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October 31, 2014

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803
Via email comments@pcaobus.org

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

Dear Public Company Accounting Oversight Board Members:

On behalf of the Financial Reporting Committee (the "Committee") of the American Academy of Actuaries[1], I am pleased to provide comments on the Public Company Accounting Oversight Board's (PCAOB or the "Board") *Auditing Accounting Estimates and Fair Value Measurements* staff consultation paper. Actuaries are involved in preparing, evaluating and, auditing a wide variety of estimates including pension benefit obligations, health retiree benefits, insurance company unpaid claim obligations, liabilities for insurance contracts, deferred acquisition cost assets, self-insurance liabilities, loyalty reward obligations, and customer refunds. Some of these estimates include measurements on a fair value basis.

The Committee supports the paper's recommendation to have a single standard covering the audit of both accounting estimates and fair value measurements because: (1) fair value measurements are a sub-set of accounting estimates; (2) this approach reduces potential inconsistency, especially between level 3 fair value measurement and other accounting estimates; and (3) it is consistent with the International Auditing and Assurance Standards Board's (IAASB) approach.

The Committee believes that the auditor must either be qualified to perform audit procedures regarding an estimate or utilize the services of an appropriately qualified specialist. The type of expertise and the extent of the use of the specialist needed would be dependent on the nature and materiality of the item being estimated or measured. Qualification would be demonstrated through attained education and experience and may be evident, in part, by professional credentials. For example, the audit procedures for the various types of insurance or pension liabilities should include a review by an appropriately qualified actuary with respect to the specific types of liabilities.

[1] The American Academy of Actuaries is an 18,000+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

The relationship between this proposed standard and the standard addressing the use of the work of a specialist in the audit is an important one. A specialist can take any of several roles: a member of the audit engagement team, a third party hired by the audit firm not on the audit engagement team, an employee of the reporting company or a specialist hired by the reporting company. The roles of these specialists—who have met applicable education and experience requirements and follow a set of developed standards of practice (as is the case with credentialed actuaries)—need to be understood and managed appropriately in the context of the development of an audit conclusion.

The Committee supports the principles of Generally Accepted Auditing Standard (AU) 336 of the AICPA. In particular, an auditor may use the findings of an in-house specialist, with the exception of insurance company loss reserves as noted in footnote 4 in AU 336, or external company specialists by (1) obtaining an understanding of the methods and assumptions used by the specialists, (2) making appropriate tests of the data provided to the specialists, and (3) evaluating whether the specialist's findings support the recorded reserves; or perform other test work such as an independent analysis.

The examples covered by this consultation paper appear to be limited to certain areas of valuation. We recommend that the PCAOB provide guidance that covers the full range of estimate types, rather than a limited number.

In response to PCAOB's specific questions on the proposed standards, the Committee would like to offer feedback 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?*

Staff should consider that the use and role of specialists (the IAASB refers to these as "experts") is important in two contexts: (1) the management's development of estimates and measurements and (2) the auditor's auditing of such estimates and measurements. Both management and the auditor can use qualified specialists that are either within their organizations or are contracted third parties for their respective roles.

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?*

Although relevant accounting standards have different requirements, the Committee believes that there are more common aspects than differences, especially relating to level 3 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?*

The Committee suggests the PCAOB should take into account the Financial Accounting Standards Board's (FASB) proposed changes to the accounting for insurance contracts, especially those of long duration. Although the guidance is not finalized, it is likely a greater emphasis will be placed on current estimates within long duration insurance contracts, i.e., estimates that are updated at least annually that relate to cash flows that in some cases will not occur for many years in the future.

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?*

One lesson learned is that there could be a need for supplementary education material, possibly in an appendix or other education material relevant to specialized topics because not all auditors may have specific education and experience relative to complex assets or liabilities such as derivatives, retirement benefit programs, or insurance contracts.

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

The Committee has not identified any elements, other than corresponding references to the use of the results of specialists.

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

It may be useful to verify that the requirements of regulators, including the National Association of Insurance Commissioners (NAIC), are considered. In particular, the Committee recommends reviewing SSAP 55.12 and SSAP.11. According to SSAP 55.12, management's analysis (in determining the estimate) "shall include an analysis of the amount of variability in the estimate." The same paragraph says "no single … reserve can be considered accurate with certainty." SSAP.11 states "No single projection method is inherently better than any other in all circumstances. The results of more than one method should be considered." While these sections provide the guidance for the estimate and not the audit, they should be considered when auditing the estimate.

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

The Committee provides no recommendation on the structure, as long as the requirements are expressed clearly. The Committee suggests organizing the requirements in a manner consistent with the material covered in the International Standards on Auditing (ISA) 540.

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

The Committee has not identified any changes to the existing requirements, although addressing the use of the models and assumption setting governance would be appropriate to cover.

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 Statement No. 12?

The Committee agrees the potential amendment is appropriate, although, as mentioned elsewhere, the role of various specialists should be clearly identified and relevant to the other standards referenced.

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?

Data quality and management of in-house and external specialists need to be properly covered.

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

The use of specialists, as discussed later in the consultation paper, and the company's governance process for deriving the estimates (including approvals and independence) should be incorporated. The degree of complexity in the models used to derive estimates (or ranges of estimates) needs to be tempered by judgment, both in derivation and audit review.

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

The Committee believes this needs to be assessed on a case-by-case basis, depending on the facts and circumstances, such as materiality of the items estimated or measured, and the uncertainties and sensitivities involved. For example, for most, but not all insurance companies, liabilities associated with insurance contracts would represent significant risks; however, in some cases the liabilities of insurance contracts may not be material or are relatively minor in relation to liabilities or to the surplus of the company. It is important to note that some insurance contract liabilities do not involve estimates. For example, the reserves for universal life contracts without significant secondary guarantees do not necessarily involve estimation and may have little risk because they are equal to the account value.

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?

In some cases, intensive interim review procedures are needed (e.g., if assumptions are changed in the third quarter) due to what is usually a relatively short time available for review of financial statement items and the basis of their estimates and measurements. This timing needs to be addressed in the course of audit planning, especially involving specialists who are part of the audit engagement team.

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

This guidance will be helpful to small firms where much of the background information is not as well-known and organized as in larger firms.

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

The Committee has identified the emphasis on testing data quality and controls over the governance of models, assumptions, and external specialists as specific requirements that would be useful.

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?

Appropriate auditing procedures relating to significant risks inherent in estimates and fair value measurements need to be considered for inclusion. Sensitivity testing may be needed to determine whether risk (assumption) is significant or not. The procedures included in ISA 540 should generally be considered.

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?

Materiality, risks, and uncertainties associated with the accounting estimates and fair value measurements could affect the auditor's selection of approaches related to testing accounting estimates. The size and consistency over time of audit ranges relative to other aspects of the company's financial statements also need to be considered. Results of initial back-testing from expectations set in a previous analysis may indicate the appropriateness of previous methods and assumptions and assist in determining where additional procedures may be needed during the current audit, such as an independent calculation of the estimate.

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

The Committee notes that there are a wide range of items that can require different methods of validating. For example, a one-year look-back might be appropriate for certain risks while for others it would not be, such as long-term mortality expectations. Instead, experience studies might be appropriate for assessing estimates related to items like mortality. Other methods may include trend testing and benchmarking against similar estimates. Although general principles might be appropriate, their application may be very different depending on the situation.

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?

Yes, the potential requirements are appropriate. The Committee would note that in certain cases multiple methods, alternative assumptions, multiple models, alternative levels of detail, and other technical judgments are considered in deriving accounting estimates.

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?

Consistency with professional practice (e.g., in the case of insurance contracts and employee benefits) would be relevant. Consequently, the PCAOB may want to consider the standards of practice or statements of principles issued by relevant professional bodies.

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

The Committee does not believe the requirement described would present difficulty in practice. Although the absence of an assumption is, in itself, an assumption, we believe that the focus of the second question relates to lack of explicit identification of assumptions made – in most cases, where significant, assumptions should be made in an explicit manner. We agree that it would be appropriate given the importance of identifying such significant assumptions.

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?

In certain cases, the effect of assumptions around risk mitigation techniques, such as reinsurance, that have been implemented prior to the report date should be considered.

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

The Committee suggests emphasizing the associated risks, uncertainties, and the process used to derive and approve the significant assumptions.

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?

One consideration the Committee identified is data quality, especially for data that are significant in the determination of estimates and measurements.

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

The Committee emphasizes the need for a consideration of appropriate audit estimate ranges. As actuaries, we realize that the future is uncertain and that there may be a range of reasonable assumptions. Of course, these have to be assessed in the development of acceptable ranges, which are a function of the uncertainties and materiality involved.

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

Additional considerations that should be addressed include (1) the independence, education and experience of the third party, (2) the data used as input by the third party source, and (3) the materiality of the item valued and the uncertainties involved. The complexity of some models makes them difficult to assess – i.e., the more opaque or "black box" the model, the more challenging is the assessment for reasonableness of the assumptions made. This requires the effective use of specialists in these cases by the auditor, either in the audit engagement team or as a third party advisor to the team. Thus, appropriate references to requirements associated with the use of experts in the audit are important. It may be the case that separate educational material may prove useful with respect to pricing services or actuarial modeling.

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?

As appropriate, testing needs to be performed by the audit team in conjunction with specialists on the team –where the associated risks and uncertainties are significant. The quality of the data used in both the derivation of estimates and measures and in the review of the estimates and measures can be quite important and needs to be considered.

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

Sensitivity analysis is important in many cases. Such a requirement, however, is not necessary when the item is not material and uncertainties do not warrant. In other cases, the sensitivity analysis may not be meaningful (such as if the resulting range is large). Accordingly, the auditor should exercise judgment to assess the need for such analysis.

In other cases, considering the nature of the recorded amounts and the auditor's assessment of the risk associated with those amounts, the auditor may conclude that some other approach is appropriate. In these cases, we support continued application of the principles of AU 336.

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

The Committee agrees that the potential requirements are appropriate for both accounting estimates and fair value measurements. The issue of evaluating audit evidence from events or transactions that occur subsequent to the measurement date through the date of the auditor's report is common and clarity is needed.

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 data through the date of the auditor's report?

We believe that a subsequent event or transaction differing from expected through the date of the audit report is not sufficient evidence in itself that the initial estimate was incorrect. There needs to be consideration of data, assumptions, models, estimators and process followed in the context of the significance of the uncertainties associated with the estimates and measurements involved.

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?

These requirements could create issues for smaller firms if they do not have access to appropriate specialists. However it is uncommon that smaller firms are involved in companies with items that are inherently complex in nature and are significant in relation to their financial statements. If these companies do not have or cannot use appropriate specialists or specialist knowledge, they should probably not be involved in audits that require such experience and skills.

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?

Conceptually, the audit should not use the same third party used by management, even if it is difficult to avoid. A specialist should not be responsible to two principals. Even with the appropriate safeguards, we cannot predict situations where the concerns over using a third party for both the audit and the management can be adequately addressed, such as if there is only one source of pricing service.

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

The Committee agrees that the factors noted above help the auditor in evaluating the reliability and relevance of evidence obtained from third party pricing sources.

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

The Committee has not identified where there is a need to differentiate between the use of a third party pricing source and a specialist, such as an actuary. They both use data, assumptions, and models in their estimation processes, even though the sources of information and techniques may differ. There are some whose assumptions and methods in their proprietary models can be difficult to identify and understand for those not intimately experienced in such estimates and measurements.

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

Actuarial publications such as *Variance* contain numerous papers concerning risk and uncertainty which are referred to in preparing estimates for financial statements. It may also be prudent to review actuarial exam syllabi, as they are updated often, and the Actuarial Standards Board's Actuarial Standards of Practice (ASOP), as the Board reviews and updates several each year, as well as developing new standards.

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Thank you for this opportunity to provide our views on PCAOB's proposed standard-setting activities related to auditing accounting estimates and fair value measurements. We would be happy to provide you with further assistance as you consider developing this new standard. If you have any questions or would like to discuss these issues in more detail, please contact Lauren Sarper, the Academy's senior policy analyst for risk management and financial reporting, at 202.223.8196 or sarper@actuary.org.

Sincerely,

Leonard Reback, MAAA, FSA
Chairperson, Financial Reporting Committee
Risk Management and Financial Reporting Council
American Academy of Actuaries