August 15, 2016

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

Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standard - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, *and Related Amendments to PCAOB Standards*

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) reproposal of Proposed Auditing Standard - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Related Amendments to PCAOB Standards* (the Reproposal). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Similar to views previously expressed on this topic, the CAQ applauds the PCAOB's efforts to consider ways to update and enhance the auditor's reporting model to provide additional information to stakeholders in an increasingly complex and global environment.[1] We recognize that the Board has been working diligently since the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release) in June 2011 to develop an approach that is beneficial to all stakeholders. We appreciate the extensive outreach and commend the Board for its responsiveness to concerns raised and recommendations made by a variety of stakeholders throughout the process, including those of the CAQ.

[1] See comment letters from the CAQ on this topic dated June 28, 2011, September 30, 2011, December 11, 2013, January 30, 2014, and June 19, 2014.

We have organized our observations and suggestions on the Reproposal into the following categories:

- Critical Audit Matter(s) (CAM)
- Additional Improvements to the Auditor's Report
- Applicability
- Effective Date

We have also included an Appendix to help illustrate some of our recommendations with respect to the illustrations included in the Reproposal related to communication of CAM.

Critical Audit Matter(s) (CAM)

Determination of CAM

The CAQ supports narrowing the source of CAM to those matters communicated, or required to be communicated to the audit committee. As indicated in our previous CAQ comment letters, we believe that narrowing the source of potential CAM to those matters discussed with audit committees will assist auditors in identifying matters that involved especially challenging, subjective, or complex auditor judgment in the audit in an effective and efficient manner. We believe narrowing the sources of potential CAM in this way will also enhance the ability for auditors to communicate only the most important matters to users of the financial statements (i.e., including too many matters in the auditor's report would serve to minimize the intended emphasis on the matters of most significance). The CAQ's 2014 field testing initiative observed that 98 percent of matters determined to be CAM had been previously communicated to the audit committee. The field testing also indicated that potential CAM identified through the application of paragraph 8 of PCAOB Release 2013-005, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the Original Proposal) resulted in a broad population of matters to consider.[2] In many instances, the inventory of potential CAM was substantial.

This change should reduce differences between the PCAOB's CAM approach and the International Auditing and Assurance Standards Board's (IAASB) approach to determining key audit matters (KAM), which are determined from those matters communicated with those charged with governance.[3] Stakeholder feedback gathered by the IAASB supported the approach as being "responsive to investor requests for further insights

[2] See CAQ comment letter from June 19, 2014 for full details on the field testing: https://pcaobus.org//Rulemaking/Docket034/247b_CAQ.pdf.

[3] Definition of *key audit matter* in ISA 701: Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. https://www.ifac.org/system/files/publications/files/ISA-701_2.pdf. See also, IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal* (May 2016), available at https://www.ifac.org/system/files/publications/files/IAASB-Auditor-Reporting-Comparison-between-IAASB-Standards-and-PCAOB-Reproposal_0.pdf. The IAASB document observes that the framework for determining CAM under the PCAOB Reproprosal is substantially similar to determining Key Audit Matters (KAM) under the IAASB's Standards.

into auditor communications with the audit committee."[4] It was also viewed as consistent with the overarching role of the audit committee to represent the interests of shareholders.[5]

Original Company Information

As shared in our prior comment letters, the CAQ developed a set of guiding principles to frame our recommendations related to auditor reporting. One of the primary guiding principles was that the auditor should not be the original source of information about the company (i.e., should not provide information in the auditor's report about the company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure). Further, during the May 11, 2016 open meeting where the Board voted to release the Reproposal for public comment, statements were made by members of the Board that the intent of certain clarifications made in the Reproposal were to prevent the auditor from being the original source of information about a company through the identification of a CAM.[6] This intent appears to be a primary reason for the inclusion of materiality in the definition of a CAM. We therefore support including the concept of materiality in the definition of a CAM and appreciate the PCAOB's change in the Reproposal in this regard. As recommended in our previous comment letter on the Original Proposal, the addition of the concept of materiality for consideration when determining CAM will focus the auditor on those matters that are most critical to the financial statements and that, as a result, are most critical to the audit. However, we do not believe that the revised definition, when combined with the factors in paragraph .12 of the Reproposal, fully aligns with the Board's intent that the auditor not be the source of original information about the company in the determination of a CAM.

For example, a significant deficiency in internal control is a required communication to an audit committee that may relate to one or more accounts or disclosures that are material to the financial statements. If the significant deficiency involved especially challenging, subjective or complex auditor judgement, it could meet the definition of a CAM. As such, the matter could be identified in the auditor's report; however, management has no requirement to disclose a significant deficiency under the SEC rules.

We believe the suggested edit below to the definition of a CAM in paragraph .11 and .A2 of the Reproposal will still provide investors with the information they are looking for about the audit, while preventing certain types of original company information, such as a significant deficiency, from meeting the definition of a CAM. A significant deficiency may *relate to* a material account or disclosure; however, a significant deficiency by itself would not be a material matter to the financial statements. We believe the revised definition will most likely prevent other potential items that are not required to be disclosed by management, but relate to accounts or disclosures that are material to the financial statements from being a CAM.

> .11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee

[4] Staff of the IAASB, *Basis for Conclusions: Reporting on Audited Financial Statements – New and Revised Auditor Reporting Standards and Related Conforming Amendments*, p.12 (Jan. 2015), available at https://www.ifac.org/system/files/publications/files/Basis%20for%20Conclusions%20-%20Auditor%20Reporting%20-%20final.pdf.

[5] Ibid.

[6] See statements by Lewis H. Ferguson https://pcaobus.org/News/Speech/Pages/Ferguson-statement-ARM-051116.aspx and Jay Hanson https://pcaobus.org/News/Speech/Pages/Hanson-statement-ARM-051116.aspx.

and that: (1) **~~relates to accounts or disclosures~~ ~~matters that are~~ is** material to the financial statements **taken as a whole**[7] and (2) involved especially challenging, subjective or complex auditor judgment.

Further, we foresee a potential situation where auditors would, under the Reproposal, identify a CAM related to an account or disclosure that would not otherwise require especially challenging, subjective or complex auditor judgment, but could result in especially challenging, subjective, or complex auditor judgement regarding the audit approach to be employed to an account or disclosure due to a significant deficiency in the company's internal controls. In this case, even though the significant deficiency would not likely be a CAM in and of itself, judgments about the audit strategy could be principal considerations that led the auditor to determine the matter was a CAM based upon the factors in paragraph .12. As a result of it being a principal consideration, the significant deficiency could require disclosure in the communication of the CAM in the auditor's report. Such disclosure could result in the auditor being the original source of information about a company's system of internal control in an area where there was no similar disclosure requirement for the company.

To help further prevent auditors from being the original source of information for a company, we recommend the Board consider revising the factors to determine whether a matter involved especially challenging, subjective, or complex auditor judgment, in paragraph .12, as shown below. We believe that removing "determining" from the second factor will focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence, as opposed to an audit strategy decision. Additionally, the nature of audit evidence is a component of determining whether sufficient appropriate audit evidence has been obtained. To clarify how the auditor should consider one of the many factors involved in the evaluation of audit evidence, we are recommending that the last factor be removed, and the consideration for obtaining sufficient appropriate audit evidence be included in the third factor (c). These recommendations are illustrated below.

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a) The auditor's assessment of the risks of material misstatement, including significant risks;
b) The degree of auditor subjectivity in **~~determining or~~** applying audit procedures to address the matter or in evaluating the results of those procedures;
c) The nature and extent of audit effort required to **obtain sufficient appropriate audit evidence to** address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
d) The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty; and
e) The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions.
~~f) The nature of audit evidence obtained regarding the matter.~~

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

[7] Please see below the *Introductory Language* section of the comment letter.

In addition, we suggest that the Board also consider revising note 2 of paragraph .14 to clarify that the auditor will not be the source of original company information:

> When describing critical audit matters in the auditor's report the auditor **should not** ~~is not expected to~~ provide information about the company that has not been made publicly available by the company **~~unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit~~**.

These suggested revisions would also be consistent with the following statement in the Reproposal: "The Board believes that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; unusual transactions; and other significant changes in the financial statements."[8]

Communication in the Auditor's Report

We appreciate the inclusion in the Reproposal of the illustrations of example CAM communications. We expect that many auditors will utilize these illustrations as a resource to develop their own CAM communications, and therefore we want to ensure the content of the illustrations aligns with the principles of the Reproposal.

The Reproposal would require that each matter communicated in the auditor's report include a description of the principal considerations that led the auditor to determine the matter is a critical audit matter, as well as a description of how the matter was addressed in the audit. The illustrations included in the Reproposal seem to indicate that all aspects of how the matter was addressed in the audit be included in the description of the CAM. In the CAQ's previous comment letter on the Original Proposal, we recommended that the Board explicitly state that the auditor may provide a description of the CAM's effect on the audit if the auditor considers it necessary in describing why a matter is a CAM. Both examples in the Reproposal provide information on how the matter was addressed in the audit beyond what would appear to be key or critical audit procedures directly related to the principal considerations that resulted in the CAM, including detail about every phase of the audit. We believe that the PCAOB should consider revising the examples to make clear that they are intended to illustrate how an auditor may describe the *principal* considerations that led the auditor to determine that the matter is a CAM and the principal way in which the auditor addressed the CAM. We believe this would more clearly demonstrate the Board's intent on page 32 of the Reproposal. Otherwise, we are concerned that the examples could be interpreted by auditors to require additional detail, beyond the principal considerations and the principal way in which the CAM was addressed, which could result in boilerplate CAM communications.

Please see the Appendix, which illustrates suggested changes to the examples included in the Reproposal to demonstrate what we believe were the *principal* considerations that lead the auditor to determine the matter was a CAM, and the principal audit procedures related to those considerations.

Legal Implications for Auditor Liability

As before, the Board has inquired whether expanded auditor reporting as set forth in the Reproposal would increase legal liability. As communicated in previous CAQ comment letters,[9] an auditor can be liable under

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[8] See p. 2 of the PCAOB Release 2016-003.
[9] See the CAQ's comment letter on the Original Proposal (link).

the federal securities laws for the statements it makes in the auditor's report, and enhanced auditor reporting inevitably increase the risk of litigation over liability.

Some of the changes in the Reproposal mitigate this risk, but the addition of the requirement to describe how the CAM were addressed in the audit could significantly increase it. The CAQ accepts that this is a necessary consequence of the communication requirement under the Reproposal. However, the Board should recognize the potential for adverse impact on auditors and on communication between auditors, companies and audit committees, and it should design the standard to avoid or reduce that impact where possible.

This idea underlies several of the modifications suggested in this comment letter. In particular, as discussed above under the "*Original Company Information*" section, the Reproposal should be modified so the auditor is not the required to include original company information in the auditor's report. Requiring the auditor to include information in its report, when the ultimate source should be the company, is unnecessary, and it creates a risk of liability that could have unintended consequences for the auditing process and the communication among the auditor, the company and the audit committee.[10]

Auditors may also be exposed to litigation from companies for exposing their original information under contract and state law duties of client confidentiality.

Introductory Language

We are supportive of introductory language preceding the description of the CAM in the auditor's report to make clear that the communication of CAM does not imply that the auditor is providing a separate opinion on the CAM or the accounts or disclosures to which it relates. However, we do have the following observations and recommendations for enhancements to the introductory language.

The language in the audit report introducing CAM, as proposed, refers to the auditor's opinion on the financial statements taken as a whole. That accurately reflects the requirements of paragraph .01 in the Reproposal. We believe that same language should also be included in the introductory language that defines a CAM. We would also recommend greater precision, as noted below, in the proposed language introducing the CAM that starts "Critical audit matters do not alter…"; we believe the subject of the sentence should be the auditor's communication of the CAM, not the CAM themselves.

The following markup of the CAM introductory language reflects the discussion above.

> The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that (1) **~~relate to accounts or disclosures that~~** are material to the financial statements **taken as a whole** and (2) involved our especially challenging, subjective, or complex judgments. **~~Critical~~ The discussion of critical** audit matters **~~do~~ does** not alter in any way our opinion on the financial statements taken as a whole, and we ~~do~~ **~~not provide~~ are not, by communicating the critical audit**

[10] One of the potential sources of auditor liability is Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and the Supreme Court has held that a person cannot be held liable for a false or misleading statements under these provisions unless the person actually makes the statement. *Janus Capital Group v. First Derivative Traders* 131 S. Ct. 2296 (2011). Another potential source of auditor liability is Section 11 of the Securities Act of 1933, and an auditor can be held liable under this provision for statement and omissions in its report.

matters below or otherwise, providing separate opinions on ~~the~~ critical audit matters **~~or on the accounts or disclosures to which they relate~~**.

Additional Improvements to the Auditor's Report

Clarifications of Existing Auditor Responsibilities

We continue to support the Board's proposed changes to enhance the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding financial statement notes and for obtaining reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Further, we also support moving the opinion paragraph, as the requirement to put the opinion paragraph first in the auditor's report more closely aligns the auditor's report with the IAASB standards.

In an effort to create further alignment with IAASB standards, we strongly encourage the Board to adopt the additional improvements to the auditor's report that are consistent with the IAASB standards. These additional changes are expanded descriptions of the responsibilities of management and those charged with governance, as well as the auditor's responsibilities, in separate sections of the report. We continue to believe that these changes would enhance users' understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally.

Also in line with IAASB standards and our recommended edits for the CAM introductory language, we encourage the PCAOB to consider revising paragraphs .08(e) and .09(b) to change the words "the financial statements" to "the financial statements, taken as a whole."

Audit Firm Tenure

Because we do not see a correlation between auditor tenure and audit quality, and consistent with our past views, the CAQ does not support including auditor tenure in the auditor's report. The PCAOB itself has acknowledged in the Original Proposal that it had not found a correlation between auditor tenure and audit quality,[11] and in the Reproposal stated that academic research is still divided on the relationship between auditor tenure and audit quality.[12] We believe that including auditor tenure in the auditor's report would create the false impression that a correlation exists between auditor tenure and audit quality and would give undue prominence to this information. Accordingly, we do not believe the auditor's report is the appropriate location to disclose auditor tenure. We do support other ways of making auditor tenure more transparent. For example, if the audit committee believes that the tenure of the auditor is important information for users of the financial statements to be aware of, the audit committee report in the proxy is an appropriate place for such disclosure. In fact, we are seeing an increasing number of audit committees of the S&P 500 disclosing the tenure of their auditors, from 47 percent in 2014 to 54 percent in 2015, according to the *2015 Audit Committee Transparency Barometer*.[13] Preliminary research by Audit Analytics for the *2016 Audit Committee Transparency Barometer* show that this trend continues with the percentage increasing from 54 percent in

[11] See Original Proposal, page A5-16.
[12] See page 49 of the PCAOB Release 2016-003.
[13] According to *2015 Audit Committee Transparency Barometer,* in 2015 approximately 54% of Audit Committees for S&P 500 Companies disclose the length of time the audit firm was engaged by the Company. http://www.thecaq.org/docs/default-source/reports-and-publications/2015-audit-committee-transparency-barometer.pdf?sfvrsn=2.

2015 to 59 percent in 2016. As audit committees are charged with responsibility for oversight of the auditor, including their appointment, we are encouraged by this increasing transparency being provided in proxy statements.

Applicability

The CAQ is supportive of the Reproposal's provision to not require the identification, communication, and documentation of critical audit matters in auditor reports for non-issuer brokers and dealers, investment companies (that are not business development companies), and employee benefit plans (i.e., employee stock purchase, savings, and similar plans). We are pleased to see the PCAOB's consideration of comments received and economic analysis to develop an informed decision for excluding these entities from CAM requirements.

Consistent with our comment letter on the Original Proposal, we believe that the Reproposal should be applicable to emerging growth companies (EGCs).[14] As we have noted previously, certain financial reporting risks can be more prevalent with EGCs than other public companies because of the size, nature, and complexity of their business model, capital structure, business processes and controls, and regulatory environment.

Effective Date

The preparation for and implementation of the Reproposal as it relates to expanded auditor reporting will take a considerable amount of time. In anticipation of implementation, audit firms will need to develop and implement training and effective quality control processes to support expanded communications that are (1) providing users with meaningful and useful information, (2) in compliance with applicable laws and regulations, and (3) not unnecessarily increasing potential legal liabilities. We also believe that the auditor's process of developing communications related to CAM will likely require extensive discussions with preparers and audit committees as they evaluate the potential effect of the additional auditor communications in the auditor's report.

We believe that the implementation of the Reproposal, particularly the effort to develop and deliver training and implement effective quality control processes, could place a significant and possibly disproportionate burden on smaller audit firms. As a result, we recommend that the Board allow for a two-phased adoption of the Reproposal. The first phase would be applicable to large accelerated filers with an effective date for audit periods ending two years after the SEC approves the final standard. The second phase would be applicable to all accelerated and non-accelerated filers one year after the phase one effective date in order to allow for firms to benefit from the experience of audits of large accelerated filers. Another benefit of a phased approach is that the PCAOB could leverage its inspection observations during inspections of audits performed during the first phase and provide insights to assist in phase two adoption.

We encourage the Board to take these matters into consideration when determining an effective date that will allow audit firms and preparers the necessary time to develop the appropriate processes, policies and procedures to implement the new standard.

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[14] See the CAQ's comment letter on the Original Proposal (link).

The CAQ appreciates the opportunity to comment on the Reproposal and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

CC:
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Arnold Schilder, Chairman

Appendix – Suggested Modifications to the Illustrations

Company A
Critical Audit Matter
The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Allowance for Loan Losses – New Loan Product

As more fully described in Note 7 to the financial statements, during 2014, the Company [a mid-size regional bank] began actively marketing a nine-year auto loan in addition to the three- and five-year auto loans historically marketed. At December 31, 2015, the nine-year loans represented approximately 18% of the auto loan portfolio. ~~The Company estimates and records an allowance for loans that are impaired but are not yet specifically identified (collective impairment allowance) by developing a loss rate based on historical losses and other factors, including qualitative adjustments to historical loss rates based on relevant market factors.~~ Since management has limited historical loss data for the nine-year loans, it developed a new model to estimate this allowance using historical loss data from its auto loans of shorter terms and loss data from external sources for auto loans of longer terms to model a loss rate for the nine-year loans. In addition, management made qualitative adjustments to the historical loss rates to reflect lower borrower quality and higher risk of collateral impairment compared to its shorter term loans and for economic factors, primarily due to increasing unemployment in the markets served. There was a significant amount of judgment required by management when developing the model, which in turn involved our significant judgment.

The principal considerations for our determination that the allowance for loan losses for nine-year auto loans is a critical audit matter are that it is a new loan product with limited historical loss data and auditing the estimated allowance for losses on these loans involved our complex and subjective judgment.

Our audit procedures related to the collective impairment allowance for the nine-year loans included the following procedures, among others.

~~We tested the effectiveness of controls over the Company's new model, historical loss data, and the calculation of a loss rate.~~ We evaluated the qualitative adjustment to the historical loss rates, including assessing the basis for the adjustments and the reasonableness of the significant assumptions. ~~We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.~~

We used a specialist to assist us in evaluating the appropriateness of the new model and to review the loss data from external sources used by the Company to determine its relevance to the Company's nine-year loan portfolio and consistency with external data from other sources.
Finally, with the assistance of the specialist, we evaluated the incorporation of the applicable assumptions into the model ~~and tested the model's computational accuracy~~.

Company B
Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Accounting for Acquisitions
Refer to Notes 2 and 13 to the financial statements

~~The Company's strategy includes growth by acquisition. Acquisitions represent a significant component of the Company’s sales growth through the addition of new customers and new products~~ During 2015 the Company completed eight acquisitions for net consideration of $2.1 billion. The most significant of these were (1) the acquisition of all outstanding equity of ABC Inc. for net consideration of $1.1 billion and (2) the acquisition of all outstanding equity of XYZ Corp. for net consideration of $0.5 billion.

Auditing the accounting for the Company’s 2015 acquisitions involved a high degree of subjectivity in evaluating management's estimates, such as the recognition of the fair value of assets acquired and liabilities assumed. We planned and performed the following procedures in connection with forming our overall opinion on the financial statements. ~~We tested controls over the accounting for acquisitions, such as controls over the recognition and measurement of assets acquired, liabilities assumed, and consideration paid and payable, including contingent consideration.~~ For each of the acquisitions, we ~~read the purchase agreements,~~ evaluated the significant assumptions and methods used in developing the fair value estimates, and tested the recognition of (1) the assets acquired and liabilities assumed at fair value; (2) the identifiable acquired intangible assets at fair value; and (3) goodwill measured as a residual.

More specifically, for the acquisitions of ABC and XYZ, we assessed whether (1) intangible assets, such as acquired technology, customer lists, and noncompetition agreements, were properly identified, and (2) the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable. Specifically, when assessing the assumptions related to the revenue growth rate and projected profit margins, we evaluated whether the assumptions used were reasonable considering the past performance of ABC and XYZ and the Company’s history related to similar acquisitions and considered whether they were consistent with evidence obtained in other areas of the audit, such as assumptions used by the Company in its budget.

The purchase consideration for the acquisitions of ABC and XYZ also reflected, in part, the estimated fair value of significant contingent consideration arrangements based on attainment of product development milestones and patent approvals. In testing the valuation of contingent consideration, we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable. Finally, we evaluated management’s classification of contingent payments to continuing employees as either contingent consideration in the business combination or employee compensation.