Comment on PCAOB Rulemaking Docket Matter No. 043

I respectfully submit my views for the Board's consideration related to its proposed standard on auditing estimates, including fair value measurements. The views expressed herein are my own and do not necessarily represent the views of my firm.

Just as the Accounting Standards Codification (ASC) differentiates between various accounting estimates and the concept of fair value, [1] I posit that the standards for the auditing of fair value measurements should be differentiated from those of other accounting estimates. The Board itself differentiates fair value estimates as a subset of accounting estimates in the proposed standard.[2] Despite this differentiation, the Board seeks to extend the required audit procedures for accounting estimates generally to be consistent with those required for fair value measurements.[3]

The concept of fair value is no doubt an estimate. Notably, fair value measures classified in "level III" of the fair value hierarchy defined by ASC 820 involve various subjective inputs and assumptions that do not have observable market sources. However, the goal of a fair value estimate is inherently and significantly different than that of other accounting estimates. Fair value intends to show a price that could be received to sell an asset in an orderly transaction between willing market participants.[4] Other accounting estimates (e.g., the allowance for loan and lease loss ("Allowance")) do not purport to represent such a precise concept but instead represent management's *best estimate* of probable events that may or may not occur in the future.

In illustrating this point, I take the Allowance accounting estimate as an example. The Allowance estimate is inherently a loss contingency. Such contingencies should be recognized when 1) it is probable that an asset has been impaired or a liability incurred and 2) when such a loss is *reasonably estimable.*[5] The definition of a contingency provided in the ASC glossary is as follows:

> *An existing condition, situation, or set of circumstances <u>involving uncertainty</u> as to possible gain (gain contingency) or loss (loss contingency) to an entity that <u>will ultimately be resolved when one or more future events occur or fail to occur</u>.* [6] *(Emphasis added)*

By the nature of its definition, loss contingencies include uncertainty and concern events that the definition itself acknowledges may or may not ever occur. This is a far cry from the estimate of fair value, which involves determining prices that could be received *today* to sell an asset or transfer a liability. Under current accounting and regulatory guidance, financial institutions are instructed to "develop and document a systematic methodology[7]" and to apply their Allowance methodologies in a "systematic and

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[1] See, for example, the exceptions to the scope of ASC 820 (ASC 820-10-15), which include among other items, accounting estimates for asset retirement obligations and share-based payments.
[2] PCAOB Proposed Auditing Standard, *Auditing Estimates, Including Fair Value Measurements and Proposed Amendments to PCAOB Auditing Standards*
[3] Ibid
[4] ASC 820-10-20
[5] ASC 450-20 (emphasis added)
[6] ASC 450-20-20
[7] SAB 102

consistently-applied[8]" manner. The existing guidance given to companies in estimating the Allowance focuses on developing a systematic methodology that complies with the "incurred loss" methodology enumerated in current GAAP[9] and applying that methodology consistently period-over-period. Current guidance does not call on companies to develop intricate models supported by advanced mathematics and statistics, and many smaller public financial institutions worry that they will be held to such standards under the recently issued Current Expected Credit Loss[10] accounting model.[11] It is clear to me that the Board has begun the process of realizing the fears and concerns of these executives.

Current auditing standards require auditors to "assess the reasonableness of the accounting estimate"[12] by focusing on the appropriateness of the Company's methodology used in developing the estimates, the completeness of the information and factors considered by management in developing the key assumptions that factor into the estimate, and considering whether the various assumptions are contradicted by other data or information (including information used in the development of other accounting estimates).[13] AS 2501 provides various procedures an auditor may *consider* using to substantively test accounting estimates. However, the standard allows for auditor judgment in tailoring the specific procedures performed to the facts and circumstances of the estimate and the issuer's processes for developing the estimate.

Under the proposed standard, auditors will be required to perform procedures for all estimates that were previously performed only for estimates of fair value. As discussed previously, accounting estimates generally and fair value measurements have distinct characteristics. Requiring the performance of these new procedures for all accounting estimates inherently implies that the estimate is developed through use of quantitative models that employ mathematical and statistical techniques that produce precise calculations, fine-tuned through the input of various economic data. The introduction of this and similar standards will have the effect of introducing new requirements to financial statement preparers. Such indirect regulation has been acknowledged by Board members.[14] Do these elegant mathematical models offer better results than the employment of a systematic and rational approach informed by historical events, as qualitatively and *judgmentally* adjusted for changes in current events? If there is one thing we know about estimates, it is that they are wrong. The question we ask as auditors should not be: "is the estimate accurate to the penny." Rather, the questions auditors ask should be regarding the appropriateness of the methodology, its consistent application by management, and whether our search for potentially contradictory information yielded any indication of bias or other evidence that the estimate was not *reasonably* stated. We give ourselves too much credit when we try to say that we can audit the

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[8] Ibid
[9] ASC 310-10
[10] ASU 2016-13
[11] https://www.wsj.com/articles/banks-want-treasury-secretary-mnuchin-to-intervene-in-fight-over-new-loan-rule-1494265009
[12] AS 2501
[13] Ibid.
[14] Speech given by PCAOB member, Jay Hanson, September 15, 2016, San Francisco, CA. "[T]he PCAOB's actions do impact financial statement preparers indirectly. For example, our inspections often highlight audit deficiencies that can only be addressed if the auditor obtains more information, or different information, from their clients. In some cases, this requires clients to change aspects of their financial reporting processes."

Allowance in the same way and with the same degree of precision that we can audit the valuation of a corporate bond.

There is of course something to be said for introducing an appropriate amount of rigor into the estimation process. Our job as auditors is to challenge management's estimation methods and assumptions. However, to expect the same level of rigor in developing accounting estimates from both the largest and the smallest of the nation's public companies is unreasonable. The largest companies often have larger staffs of people designated to one estimation area than smaller issuers employ in their entire company. It is no wonder the number of public companies in the United States continues to dwindle.[15] I fear that recent standard setting activity by the Board (e.g., the proposed standard and the 2015 related parties standard) has favored too much a "one size fits all" audit approach. Such an approach treats all issuers as equal and does not provide for the allowance of auditor judgement in tailoring the audit procedures deemed necessary in light of the issuer-specific risk of material misstatement. While I am wholeheartedly in favor of the improvements made to perform procedures to identify management bias, I respectively disagree about the need to consolidate the required audit procedures for fair value measurements into the required procedures for accounting estimates more broadly.

Respectfully submitted,

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[15] Center for Research in Security Prices at the University of Chicago Booth School of Business: For instance, the number of US public companies declined by more than half since 1997