American Bankers Association
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Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Via website submission: comments@pcaobus.org

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

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on the Staff Consultation Paper – *Auditing Accounting Estimates and Fair Value Measurements* (Consultation Paper). Accounting estimates and fair value measurements are pervasive throughout bank financial statements, mainly through the allowance for loan and lease losses and the measurement of other financial assets and liabilities. Not only do the accounting estimates and fair value measurements made within bank financial statements involve significant judgment, but third-party specialists and pricing services are often used by banks of all sizes. Further, the Financial Accounting Standards Board (FASB) is expected to approve revisions to standards that will require longer and more judgmental forecasts. Therefore, any revision to the auditing standards related to accounting estimates and fair value measurements will have a significant impact on audits of banking institutions.

With this in mind, common sense and cost-effectiveness must be the guiding principles that guide the Board as it evaluates the issues discussed in the Consultation Paper. While the Consultation Paper notes that the highest number of deficiencies in audits of public companies is in the area of fair value measurement, the Consultation Paper is unclear about the types of deficiencies the staff wishes to address. As a result, bankers believe auditors will be required to unnecessarily increase audit procedures that do not lead to better audits. The result will be more expensive auditing services without sufficient return. If the Board decides to proceed with a formal proposal, we recommend these important guiding principles:

- A formal proposal to revise auditing standards should clarify the cost-effectiveness of additional audit procedures and the resulting standards should meet the cost-benefit test.
- Standards addressing specialists, pricing services, and other third-party sources, must recognize the extent of their use in the banking industry.
- Standards addressing specialists, pricing services, and other third-party sources must adjustable to the continuously changing markets, processes, and accounting standards.

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

- Standards addressing specialists, pricing services, and other third-party sources must flexible enough to make sense for audit firms of all sizes.

In fact, some of the proposed requirements, if approved, may end up requiring some banks to completely rethink their processes to procure specialists and third-party pricing services. We believe this will severely impact smaller banks and the external auditors they use. For example, the use of local auditing firms by community banks may need to be re-evaluated, as local auditing firms may not necessarily be knowledgeable of the various estimation methods "accepted" within all aspects of the banking industry and also may not have access to the extent of third-party pricing services that would avoid costly testing of the audit evidence as if it were produced by the company. While bankers believe that efficiencies can be achieved through clarification of the understanding of specialists and third-party servicers and the auditing guidance provided to them, the Consultation Paper causes banks to ask "Why not just hire two auditors?"

In the Appendix, we respond to selected questions posed in the Consultation Paper. However, our main concerns are as follows:

A formal proposal to revise auditing standards should clarify the cost-effectiveness of additional audit procedures and the resulting standards should meet the cost-benefit test.

Both bankers and investors want audits that are *both* reliable and cost-effective. Because the extent of anticipated changes in auditing procedures is not clear in the Consultation Paper, it is difficult to provide quality feedback on this point. Many audit deficiencies (those that merely reflect inadequate documentation), do not necessarily result in misstated financial statements or disclosures, and, at some level, increased costs relating to expanded audit procedures could be viewed as wasting resources.
In the vast majority of cases, the current level of audit work performed on estimates of the allowance for loan and lease losses (ALLL) and on fair value estimates is extensive. Increasing the required work for what may be little overall incremental audit assurance is counterproductive. As the PCAOB progresses toward a possible revision to auditing standards, we recommend that a framework for a risk-based cost/benefit analysis of anticipated additional procedures be performed that would apply to banks and audit firms of all sizes. Cost-effectiveness our primary concern when evaluating any proposed change, and it is central to our thought process for each of below.

PCAOB must understand the extent of the use of specialists, pricing services, and other third-party sources in the banking industry prior to issuing a final standard.

Banks of all sizes – from the smallest of community banks to the largest international banks – use service providers (specialists, pricing services, and other third-party sources) to obtain important information for financial instrument valuations as well as for key business processes and management purposes. The Consultation Paper appears to address concerns related specifically to financial instruments. However, in addition to valuation and pricing specialists mentioned in the Consultation Paper, third-parties may include:

- Real estate valuation appraisers: Fair value estimates of underlying collateral are often used by bankers in order to determine and measure impairment on the related loans. Collateral value estimates are also often the basis for initial underwriting decisions, which are also important drivers for the ALLL.

- Actuarial consultants: Similar to companies in other industries, actuarial consultants are often used to address key issues in pension accounting and certain insurance-related products.

- Asset/Liability Management (ALM) consultants: ALM consultants are often currently used to provide amortization of deferred loan fees and costs, in valuing core deposit intangibles, and in pricing certain debt securities. As noted in more detail below, ALM consultants may, in the future, also be used to provide estimates related to core deposit disclosures.

- Banking regulators: Banking institutions are subject to rigorous examinations performed by regulators as part of their supervisory and compliance responsibilities. Bank examination teams evaluate internal controls and safety and soundness issues, including valuation and measurement of impairment on loans and debt securities. Regulators also often collect and maintain peer data that become the basis for analytical review procedures performed during substantive testing of the ALLL for book purposes. The expansion of regulatory disclosure requirements (for example, under Pillar 3) may broaden such peer analysis to other key banking issues. Testing and maintenance of such data can well be considered comparable to that performed by specialists and third-party service providers.

While the Consultation Paper appears to treat third-party pricing sources differently from specialists, it is not clear how to determine the difference between the two. For example, real estate appraisers normally provide comparable sales prices of similar properties (as a third-party pricing service might), but would also provide other analyses as a basis for adjustment. Given the proposal to require auditors to test assumptions developed by a company's specialist as if it were produced by the company, the definition of "specialist" is critical and could result in very significant and unnecessary costs in the audit process. For example, we fear that market data underlying appraisals may require source testing (and testing of those underlying sources). Specialists who base their estimates on third-party data services (for example, those who provide estimates of core deposit intangibles) may also be subject to significant additional testing. Such testing is unnecessarily onerous.

We further advise the PCAOB to review whether, in many situations, regulatory bank examiners may qualify as specialists in their review of the ALLL and of other financial instruments issues. For all practical purposes, we believe that the perspectives of the bank examiners and auditors are similar and many of the same substantive tests are currently used by both parties, resulting in significant redundancy in the audit process. With this in mind, we recommend that PCAOB address how the work of regulatory examiners fit into the audit.

Standards addressing specialists, pricing services, and other third-party sources must be adjustable to the continuously changing markets, processes, and accounting standards.

By their nature, markets are decentralized and ever-changing. As a result, processes to estimate values, including fair values, are likely to change over time. The recent financial crisis has also taught us that so-called "black swan" scenarios can happen and that bankers, regulators, and auditors must be prepared to perform under those circumstances. Various regulations and regulatory responses to the financial crisis can further affect the inputs to fair values.

1. It is preferable to make incremental changes to both the standard for accounting estimates and the standard for fair value measurements, rather than comprehensively addressing both issues in one standard. We believe that the reporting objectives of accounting estimates and those of fair value measurements (and, therefore, the required audit procedures) are sufficiently different to maintain separate auditing standards.[2] As a practical matter, we further believe that a comprehensive standard will take too long, subjecting the new standard to an obsolete status upon issuance.

2. Recent trends related to centralized testing approaches are relevant factors related to any prospective auditing standard related to testing of third-party sources. However, we expect further evolution of pricing to occur, including consolidation of pricing vendors and use of sub-vendors, which could further complicate the use of third-party sources. For example, with consolidation of the pricing industry, it becomes more likely that the servicer used by the auditor will be the same as the servicer used by the bank. On the other hand, if sub-servicing is utilized by a pricing service, it may become more likely that the bank and the auditor are (through the pricing service's use of sub-servicer) using the same pricing service. In both cases, it appears that the auditor will be required to test the data as though it were generated by the bank.

   The new standard must be clear as to "how far does the auditor need to go?" in determining whether to treat the related work as though it was produced by the company. The answer to that question will affect how bankers procure such services, as they will naturally seek the most cost-efficient path. This will significantly impact community banks and their auditors the most, as the availability of qualified auditing firms and third-party sources are often limited, based on the specific markets that are served. With this in mind, ABA recommends that PCAOB reject the proposal that if the third-party source used by the auditor is the same as the third-party source used by the company, the auditor

[2] Using loans as an example, the objective of fair value measurement emphasizes the price a bank will obtain in order to sell the specific loan at a specific point in time. The objective of the accounting estimate in valuing any impairment on the loan emphasizes the amounts a bank expects to lose, given its specific expertise and knowledge of the borrower, over its holding period.

should evaluate the audit evidence obtained as if it were produced by the company. In this case, a one-size-fits-all approach will not work.

3. New standards should address practical aspects of expected changes to accounting standards that place heavy emphasis on estimates and measurement techniques. New accounting standards expected to be approved within the next year by FASB include:

    a. The estimate of the allowance for loan and lease losses (ALLL): The new ALLL estimate will involve significant long-term forecasts of future losses based on an expected life of a portfolio.

    b. Disclosure of loans at their exit price-based fair value: While disclosures of the fair value of loans is not new, most banks currently measure them at an "entrance price-based" fair value, as the vast majority of many loans – especially those loans held by community banks – are neither sold nor are there consistent and reliable transactions that would provide inputs to determine exit prices.

    c. Disclosure of certain core deposit information: Depending on the final definition of "core deposit", the new disclosure may require significant forecasts of economic activity, interest rates, and customer behavior. Such forecasts would be required if macroeconomic-based "surge" balances that exist within many core deposit accounts must be excluded from gross core deposit balances.

    These new standards will introduce new and unproven methods of estimation and measurement into the industry and the auditing profession. With this in mind, we recommend that PCAOB reject any requirement for the auditor to evaluate methods to develop accounting estimates that are "accepted within the company's industry". In addition to the practical problems of defining "industry acceptance" (especially under new accounting standards), estimation methods are expected to continuously evolve. Current practice, for example, in estimating the ALLL may vary based on company size. Further, based on how "method" is defined, methods can vary by region or even based on individual regulatory examination teams. Therefore, practical issues also face any such requirement.

Standards addressing specialists, pricing services, and other third-party sources must flexible enough to make sense for audit firms of all sizes.

Several of the proposed standards appear suitable as "best practices" to consider. However, in many cases, they might lead to inefficient testing that may unintentionally lead to inappropriate audit decisions. Further, such requirements will put on smaller auditing firms will have an adverse impact on the audits of community banking institutions. Therefore, we recommend that PCAOB reject standards that require:

- Assessing all significant assumptions, including those not identified by management: Many auditing firms, large and small, will struggle to efficiently identify the population of assumptions, evaluate the relevance and significance of each assumption.

- Testing of information provided by a bank-hired specialist as though the information was produced by the bank: Smaller auditing firms with less specific expertise will struggle in the required testing and likely increase auditing fees for little or no return to the audited bank. As the work of specialists is often produced using proprietary models developed by the specialist, such required procedures may not be possible.

As just noted, the proposed standards appear to suggest best practices to consider in many circumstances. However, they should not be requirements during the audit.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette

Appendix: Answers to Specific Questions Posed in the Consultation Paper

Certain Aspects of Current Practice

Question 2: What other issues relevant to the need for standard setting should be considered by the staff?

ABA Response: By their nature, markets are decentralized and ever-changing. As a result, processes to estimate values, including fair values, will be expected to change. Recent trends related to centralized testing approaches are relevant factors related to any prospective auditing standard related to testing of third-party sources. However, we expect further evolution of pricing to occur, including consolidation of pricing vendors and use of sub-vendors, which could further complicate the use of any third-party source. For example, within consolidation of the pricing industry, it becomes more likely that the servicer used by the auditor will be the same as the servicer used by the bank. On the other hand, if sub-servicing is utilized by a pricing service, it may become more likely that the bank and the auditor are (through the pricing service's use of sub-servicer) using the same pricing service. In both cases, it appears that the auditor will be required to test the data as though it were generated by the bank.

Overview of the Approach Considered by the Staff

Question 4: Do accounting estimates and fair value measurements have sufficiently common attributes that the audit procedures should be included with a single standard? Are there limitations to the approach of having a single standard address both auditing accounting estimates and fair value measurements?

ABA Response: It is preferable to make incremental changes to both the standard for accounting estimates and the standard for fair value measurements, rather than comprehensively addressing both issues in one standard. The reporting objectives of accounting estimates and those of fair value measurements (and, therefore, the required audit procedures) are sufficiently different to maintain separate auditing standards[3]. As a practical matter, we further believe that a comprehensive standard will take too long, subjecting the new standard to an obsolete status upon issuance.

In any new standard, it is critical that there is clarity as to the extent of and reason for additional procedures that may be required. Most identified audit deficiencies appear to result from insufficient skepticism or supporting documentation and not from a lack of testing of underlying data.

[3] Using loans as an example, the objective of fair value measurement emphasizes the price a bank will obtain in order to sell the specific loan at a specific point in time. The objective of the accounting estimate in valuing any impairment on the loan emphasizes the amounts a bank expects to lose, given its specific expertise and knowledge of the borrower, over its holding period.

Question 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?

ABA Response: New standards should address practical aspects of expected changes to accounting standards that place heavy emphasis on estimates and measurement techniques. New accounting standards expected to be approved within the next year by FASB include:

- The estimate of the allowance for loan and lease losses (ALLL): The new ALLL estimate will involve significant long-term forecasts of future losses based on an expected life of a portfolio.

- Disclosure of loans at their exit price-based fair value: While disclosures of the fair value of loans is not new, most banks currently measure them at an "entrance price-based" fair value, as the vast majority of many loans – especially those loans held by community banks – are neither sold nor are there consistent and reliable transactions that would provide inputs to determine exit prices.

- Disclosure of certain core deposit information: Depending on the final definition of "core deposit", the new disclosure may require significant forecasts of economic activity, interest rates, and customer behavior. Such forecasts would be required if macroeconomic-based "surge" balances that exist within many core deposit accounts must be excluded from gross core deposit balances.

These new standards will introduce new and unproven methods of estimation and measurement into the industry. With this in mind, we recommend that PCAOB reject any requirement for the auditor to evaluate methods to develop accounting estimates that are "accepted within the company's industry". In addition to the practical problems of defining "industry acceptance" (especially under new accounting standards), estimation methods are expected to continuously evolve. Current practice, for example, in estimating the ALLL may vary based on company size. Further, based on how "method" is defined, methods can vary by region or even based on individual regulatory examination teams. Therefore, practical issues also face any such requirement.

Question 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?

ABA Response: Banking institutions are subject to rigorous examinations performed by regulators as part of their supervisory and compliance responsibilities. Bank examination teams evaluate internal controls and safety and soundness issues, including valuation and measurement of impairment on loans and debt securities. Regulators also often collect and maintain peer data that become the basis for analytical review procedures performed during substantive testing of the ALLL. The expansion of regulatory disclosure requirements (for example, under Pillar 3) may broaden such peer analysis to other key banking issues.

While the Consultation Paper appears to treat third-party pricing sources differently from specialists, it is not clear how to determine the difference between the two. For example, real estate appraisers normally provide comparable sales prices of similar properties (as a third-party pricing service might) but would also provide other analyses as a basis for adjustment. Given the proposal to require auditors to test assumptions developed by a company's specialist as if it were produced by the company, the differentiation is critical and could result in very significant and unnecessary costs in the audit process. For example, testing the underlying market data used by appraisers and other specialists (such as those who assist in the valuation of core deposit intangibles) would be unduly onerous.

We further advise the PCAOB to review whether in many situations, regulatory bank examiners may qualify as specialists in their review of the ALLL and of other financial instruments issues. For all practical purposes, we believe that the perspectives of the bank examiners and auditors are similar and many of the same substantive tests are currently used by both parties, resulting in significant redundancy in the audit process. Regulators also provide significant peer data that is often used in analytically reviewing the reasonableness of accounting estimates. With this in mind, we recommend that PCAOB address how the work of regulatory examiners fits into the audit.

Identifying Significant Accounts and Disclosures and Significant Risks

Question 14: Is the potential amendment to Auditing Standard No. 12 described above clear and appropriate for both accounting estimates and fair value estimates? 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)?

ABA Response: While market liquidity is listed as a factor to be considered when relevant, there are many factors that underlie quick changes in liquidity. As has been exhibited during the Financial Crisis and its aftermath, market liquidity for loans and debt securities can be highly affected by regulations and expected regulation. For example, regulatory capital requirements provide significant incentive to banks to sell off certain securities in certain circumstances. Since banks hold a significant portion of many forms of debt securities, such circumstances can thus result in quickly dried-up market liquidity. Further, regulatory actions, such as implementation of the Volcker Rule and the Liquidity Coverage Ratio, may require significant sales of certain assets at specific points in time. At specific times, this can have a large impact on market liquidity. Therefore, we believe that these factors, while they could be considered as part of "market liquidity" within the standard, should be addressed within a fuller discussion on auditing fair value measurements.

As it relates to an expected change in how the allowance for loan and lease losses (ALLL) are measured, more subjectivity will be required, as forecasts of future losses will be an integral part of the estimation process. We believe that small changes in forecasted economic growth can translate to large changes in the estimated ALLL balance. Therefore, more thorough research is needed to determine how such subjectivity can be addressed within the audit process.

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

Question 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?

ABA Response: While accepted methods of valuation can be relevant factors when auditing accounting estimates and fair value measurements, we believe a requirement to formally identify and consider those methods is unnecessarily burdensome and will also burden smaller banking institutions and their auditors. An example would be the methods to estimate the ALLL used by larger banks (which may use sophisticated probability of default/loss given default (PD/LGD) models or discounted cash flow projections) compared to methods used by smaller banks (which often apply factors to annualized charge-off information). We wonder how the smaller auditing firm is expected to react by considering the PD/LGD models and question the value of such consideration.

As noted in our letter above, new accounting standards are also expected to be approved that will require new estimates and fair value measurements to be made. These new standards will introduce new and unproven methods of estimation and measurement into the industry. We recommend that the PCAOB reject any requirement for the auditor to evaluate methods to develop accounting estimates that are "accepted within the company's industry". In addition to the practical problems of defining "industry acceptance" (especially under new accounting standards), accepted estimation methods are expected to continuously evolve. Current practice in estimating the allowance for loan and lease losses, for example, may vary based on company size. Further, based on how "method" is defined, methods can vary by region or even based on individual regulatory examination teams. Therefore, practical issues also face any such requirement.

Identifying Significant Assumptions

Question 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?

ABA Response: There should be no requirement for auditors to assess all significant assumptions, including those not identified by management. Many auditing firms, large and small, will struggle to efficiently identify the population of assumptions, evaluate the relevance and significance of each assumption. As noted in our response to question 27, practices related to accounting estimates will vary, based often on the size of the banking institution. Those methods used by community bankers will normally be simpler, with significantly fewer assumptions made compared to larger institutions. To require the auditor to identify other assumptions that may not be used by the company will not only result in unnecessary costs to the audit process, but it will also cause unnecessary conflicts with banking industry regulators that often recommend certain methods and assumptions to the banks they supervise. In these cases, the benefits are unlikely to exceed the costs of additional work.

Evaluating the Reasonableness of Significant Assumptions

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?

ABA Response: Based on the following changes that FASB is expected to approve, forward-looking forecasts of the future should be considered significant factors that may addressed. Not only are future economic and market conditions considered in these estimates, but also future customer behavior.

a. The estimate of the allowance for loan and lease losses (ALLL): The new ALLL estimate will involve significant long-term forecasts of future losses based on an expected life of a portfolio. Not only should existing market information be considered, but also future market information.

b. Disclosure of loans at their exit price-based fair value: While disclosures of the fair value of loans is not new, most banks currently measure them at an "entrance price-based" fair value, as the vast majority of many loans – especially those loans held by community banks – are neither sold nor are there consistent and reliable transactions that would provide inputs to determine exit prices.

c. Disclosure of certain core deposit information: Depending on the final definition of "core deposit", the new disclosure may require significant forecasts of economic activity, interest rates, and customer behavior. Such forecasts would be required if macroeconomic-based "surge" balances that exist within many core deposit accounts must be excluded from gross core deposit balances.

Question 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?

ABA Response: Having experienced the changes in liquid markets resulting from general economic decline and from regulatory pronouncements (see question 14 above), we believe that subsequent transactions may or may not be reliable indications of fair value. While there can be situations when referring to subsequent transactions provide value to the auditing of fair values, we recommend that PCAOB reject that such procedures be required. If PCAOB ultimately approves such a requirement, we urge the Board to accompany it with guidance that illustrates circumstances in which such evidence would be inappropriate.

Use of Third Parties

Question 39: Should the potential new standard (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…) 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?

ABA Response: Such a requirement will significantly affect community banks and their auditors the most, as the availability of qualified auditing firms and third-party sources are often limited, based on the specific markets that are served. This requirement will be costly for both, as they typically do not have sufficient size to pursue a wide range of pricing firms. Additional audit testing (for example, for appraisers, actuaries, or other consultants) to re-perform a valuation or an appraisal would not be cost-beneficial.

We also expect further evolution of pricing to occur, including consolidation of pricing vendors and use of sub-vendors, which could further complicate the use of any third-party source. For example, within consolidation of the pricing industry, it becomes more likely that the servicer used by the auditor will be the same as the servicer used by the bank. On the other hand, if sub-servicing is utilized by a pricing service, it may become more likely that the bank and the auditor are (through the pricing service's use of sub-servicer) using the same pricing service. In both cases, it appears that the auditor will be required to test the data as though it were generated by the bank.

The new standard must be clear as to "how far does the auditor need to go?" in determining whether to treat the related work as though it was produced by the company. The answer to that question will affect how bankers procure such services, as they will naturally seek the most cost-efficient path. With this in mind, ABA recommends that PCAOB reject the proposal that 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. In this case, a one-size-fits-all approach will not work.