FIRCA Financial Instruments Reporting and Convergence Alliance

November 3, 2014

The Honorable James Doty
Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

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

Dear Chairman Doty:

The Financial Instruments Reporting and Convergence Alliance ("FIRCA") is a coalition of business, financial, insurance and real estate trade organizations representing all sectors of the economy and areas of the financial services arena. FIRCA recognizes that accurate and transparent financial reporting is a cornerstone of our capital markets in the United States and globally. FIRCA was formed in the wake of the 2008-2009 fair value accounting crisis and we welcome the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") Staff Consultation Paper, ***Auditing Accounting Estimates and Fair Value Measurements,*** ("Fair Value Paper").

FIRCA has concerns that the PCAOB has inferred, but not necessarily demonstrated, a problem with fair value estimates. Further, for stakeholders to benefit from the findings in the paper, it must be understood how any such audit or disclosure-based fair value practices do not take into account estimates in illiquid markets, such as for many corporate bonds. In addition to these points, FIRCA believes that the intent to combine the three different current audit standards for estimates, fair value measurements, hedging and derivatives into one standard is fraught with adverse unintended consequences and will exacerbate financial reporting complexity. FIRCA is also concerned that suggested revisions to auditing standards in the Fair Value Paper appear to be prescriptive rather than principles-based and potentially more focused on facilitating the inspection process rather than improving audit effectiveness.

The absence of a clear identification of the nature of inspection deficiencies involving the auditing of estimates, fair values, derivatives and hedging distorts the utility of the Fair Value Paper. Therefore it is not possible for FIRCA, or other stakeholders, to provide informed commentary on the Fair Value Paper.

Accordingly, FIRCA respectfully requests that the PCAOB provide stakeholders with fact based information on the nature of the problem that the PCAOB is trying to solve. Additionally, the Signatories believe that it is useful for stakeholders to understand why revising auditing standards for estimates, fair values, hedging and derivatives represents the appropriate solution to that problem. This information should include the problems uncovered during the inspections process, the scope of these deficiencies, including their materiality and significance for the financial statements and overall audit. If these problems have triggered restatements, stakeholders will need to know the rationale for why revising auditing standards for estimates, fair value measurements, hedging and derivatives will address the problems and why these standards need to be combined. Additionally, in regards to auditing hedging and derivative activities, FIRCA strongly suggests that the PCAOB work with other regulatory bodies to determine what, if any, changes are needed in auditing standards. FIRCA also renews its recommendation that the PCAOB create a Business Advisory Group to improve the information flows needed for an efficient standard setting process.

Our concerns are discussed in greater detail below.

Discussion

Many of the signatories to this letter, as well as many others, were involved in collective efforts to address issues related to fair value accounting that had erupted during the 2008-2009 financial crisis. Our concerns related to the inability to measure assets in illiquid markets and to advocate for reforms, in both accounting and auditing policies, to allow for measurements and modeling to be used when normal market conditions were disrupted. These efforts included numerous meetings and correspondence with the Financial Accounting Standards Board (“FASB”), the

Securities and Exchange Commission ("SEC"), and Congress. On March 4, 2009, the fair value accounting coalition sent a letter[1] to the PCAOB requesting it "to issue guidance and standards as to how it will impact the audits of fair value accounting in light of recent actions…" The coalition also met with the PCAOB on March 29, 2009 to advocate for action to provide for a coordinated means of guidance to ensure that both the *accounting* and *auditing* of fair value and impairments be addressed simultaneously.

These efforts culminated in the April 9, 2009 release of staff positions by the FASB ("FASB fair value reforms")[2] to improve guidance and disclosure on fair value measurements and impairments. However, the PCAOB did not take any action at that time to promulgate new guidance for auditors.[3] Now, more than five years after the crisis, it is confusing to the business community why the PCAOB has taken up this issue after it seemed to have been settled and the crisis abated.

1. April 2009 FASB Fair Value Changes

During the 2008-2009 financial crisis, markets shut down making it difficult, if not impossible, for businesses to obtain observable data to value assets. Similarly, bids of a fire sale nature, intended to drive down asset prices in illiquid markets, made some observable inputs not only worthless, but harmful to the financial well-being of a business. The FASB fair value reforms (as well as other SEC and FASB actions taken between October, 2008 and April, 2009) were designed to facilitate the use of Level III modeling for valuations in illiquid markets and how losses could be

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[1] The March 4, 2009 coalition letter to the PCAOB which is attached as an appendix to this letter.
[2] The FASB staff positions pertained to: FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly,* providing guidelines to make fair value measurements more consistent with the principles presented in FASB Statement No. 157, Fair Value Measurements; FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments,* promoting consistency in financial reporting by increasing the frequency of fair value disclosures; and FSP FAS 115-2 and FAS 124-2,*Recognition and Presentation of Other-Than-Temporary Impairments,* providing guidance for greater clarity and consistency in accounting for and presenting impairment losses on securities
[3] FIRCA appreciates that the PCAOB issued Staff Audit Practice Alerts 2, 3, and 4 on *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007), *Audit Considerations in the Current Economic Environment* (December 5, 2008), and *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (April 21, 2009), respectively. However, the purpose of staff audit practice alerts is to remind auditors of their responsibilities under existing PCAOB auditing standards, not establish new auditing standards.

recognized. These actions were meant to provide investors with appropriate decision useful information during a time of great stress on the financial system and economy.

We had hoped that the PCAOB would address potential audit issues in a more robust way with the promulgation of the April, 2009 fair value reforms. We note that the PCAOB's Staff Audit Practice Alert issued in April 2009, emphasized that the PCAOB had a project on its standard-setting agenda to address the auditing standards related to auditing accounting estimates and auditing fair value measurements.[4] However, no new PCAOB audit guidance was promulgated as businesses applied the FASB fair value reforms. Even so, after businesses applied the FASB fair value reforms the procyclical asset write downs stopped, equity prices stabilized, and investor concerns over valuations abated.

Yet a reading of the 2010 PCAOB Report would seem to reflect conditions and requirements before the April 2009 FASB fair value reforms and, therefore, we need more current and even forward-looking evidence on audit firm practices and audit performance in these areas. Our concern is that the PCAOB's findings may in fact be contrary to the state of accounting that has existed post April, 2009. While such a debate may have been appropriate in the spring of 2009, it would appear that time has passed and many of the issues of that period have been resolved.

2. Concerns with the Fair Value Paper

The Fair Value Paper states that its goal is to seek additional information to help the PCAOB staff assess the potential need for changes to standards for auditing accounting estimates and fair value measurements. Furthermore, the Fair Value Paper proclaims that the PCAOB has observed significant audit deficiencies with fair value measurements under its standards and other standards globally. In particular, the PCAOB references that International Forum of Independent Audit Regulators

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[4] *See* PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (April 21, 2009), which considered the effects the FASB's fair value reforms on audits and reviews under PCAOB auditing standards existing at that time.

("IFIAR") surveys have found the highest number of deficiencies in audits of public companies to be in the area of fair value measurement.[5]

While the IFIAR surveys may make an interesting data point, they are neither dispositive nor representative of the audited financial statements required under the laws and regulations of the United States. Deficiencies in much smaller and illiquid capital markets, with differing legal requirements, should not be a basis of action for companies that are under the jurisdiction of the SEC and audits under the jurisdiction of the PCAOB. Practices and standards can vary widely and such data may distort perceptions and conclusions rather than inform them. This is particularly dangerous as it may create flawed standards.

The fair value paper also references the 2010 report released by the PCAOB, ***Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*** ("2010 PCAOB Report"). The 2010 PCAOB Report states that through its oversight activities the PCAOB has observed significant audit deficiencies in fair value measurements. Another PCAOB report, released in 2013, is also cited in the fair value paper: ***Report on 2007-2010 Inspections of Domestic Firms that Audit 100 or Fewer Public Companies*** ("2013 PCAOB Report') to illustrate the point of oversight activities pointing to significant deficiencies in fair value measurements.[6]

However, the Fair Value Paper and the 2010 and 2013 PCAOB Reports do not provide critical information that is necessary for stakeholders to evaluate if a problem exists today or provide informed commentary to the PCAOB.

The Fair Value Paper, 2010 PCAOB Report, and 2013 PCAOB Report state that the PCAOB has "observed significant audit deficiencies in this area."[7] But, these materials provide no substantive analysis of the nature of the audit deficiencies or link to areas where auditing standards should be revised to improve practice. Indeed,

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[5] The IFIAR surveys are listed in footnote 4 of the fair value paper: *Report on 2013 Survey of Inspection Findings*, IFIAR (April 10, 2014), https://www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/Member Updates/IFIAR-Inspection-Survey-9-April-2014_1.pdf and *2012 Summary Report of Audit Inspection Findings,* IFIAR (December 18, 2012), https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR-2012-Summary-Report-of-Members-Inspection-Findings-18-Dec-12-(2).pdf.

[6] Both the 2010 PCAOB Report and the 2013 PCAOB Report are referenced in footnote 3 of the Fair Value Paper.

[7] Page 3, Fair Value Paper.

discussions at the PCAOB's special meeting of the Standing Advisory Group ("SAG") on October 2, 2014, revealed that the firms' analyses of both "best practices" on effective audits and root causes of audit deficiencies suggest that it may be helpful to focus on areas other than auditing standards for estimates, fair values, and hedging and derivatives—such as quality controls.

Further, as discussed by FASB member Larry Smith and former FASB Chairman Robert Herz at the October 2, 2014, Standing Advisory Group ("SAG") meeting, the use of estimates in financial statements prepared under U.S. Generally Accepted Accounting Principles ("US-GAAP") is long-standing and pervasive. FIRCA is unaware of any current systematic evidence that audits have failed to assess the reasonableness of these estimates in the financial statements. Moreover, any proposed changes to auditing standards with such a pervasive effect on financial reporting may have consequences that would need to be fully understood and carefully analyzed to ensure that they withstand cost-benefit considerations.

In addition, the 2013 PCAOB Report seems to include a small subset of public companies that use fair value measurements, probably too small to be representative of the larger markets. This also calls into question the utility of the findings of the 2013 PCAOB Report as a basis to determine changes to standards.

To summarize, FIRCA believes that these concerns raise important and pertinent questions which need to be answered and information provided before stakeholders can provide informed commentary, or indeed for the PCAOB to move forward on this project at all. These questions would be:

1. How many restatements have occurred as a result of problems with fair value measurements?

2. What percentage of financial reports did these "fair value" restatements represent?

3. What is the nature of any auditing deficiencies related to estimates, fair value measurement, and hedging and derivatives and what do such deficiencies suggest in the way of needed changes in auditing standards, if any, to improve audit effectiveness?

4. More specifically, what issues in terms of auditing fair value measurements would constitute an audit deficiency?

5. Have audit deficiencies been associated with inappropriate fair value measurements or estimates or compromising of investor interests in any way?

6. Are audit deficiencies in these areas associated somehow with deviations between recorded and realized values? If so, is that within the purview of the PCAOB?

7. How many public companies audits were subject to the inspections process?

8. What were the size of these companies and the industries they were involved with? Is the inspection pool of companies used in the 2010 PCAOB Report and 2013 PCAOB Report representative of the public company universe?

9. Has the PCAOB found similar issues with the valuation of corporate bonds and other fixed income products, which have been successfully audited for decades that operate in illiquid markets?

This is not an exhaustive list of questions but representative to show the type and level of detail needed for stakeholders to better understand the scope of issues and problems the PCAOB is concerned about and seeks to address. Without having this level of detail it isn't possible for commenters to give informed feedback needed for an intelligent rulemaking process.

FIRCA is also concerned about other aspects of the Fair Value Paper. For example, the Fair Value Paper indicates that the PCAOB is considering combining the existing auditing standards on estimates, fair values, and derivatives and hedging into one auditing standard. Given the heterogeneous nature of these activities and the accounting for them, such a move seems both counter-intuitive and counter-productive. In addition, FIRCA notes that the FASB's current direction is to change from an incurred loss model to an expected loss model for recording credit losses on financial instruments. This too will have its own unique accounting estimate issues. Combining this with an auditing standard for fair value, derivatives, and other accounting estimates would be a mistake. We also note that estimates are used in many other areas of accounting and auditing including, but not limited to, pensions, insurance, representations and warranties, inventory, goodwill, contingencies, valuation of mortgage servicing assets, etc. To create one auditing standard for this myriad of estimates used in preparation of financial statements would be impractical because the estimation techniques used for each are unique. All these factors also reinforce the need for principles-based auditing standards in each area—estimates, fair value measurement, and hedging and derivatives.

Further, FIRCA recommends that the PCAOB consider the issues with respect to auditing estimates, fair value measurements, and hedging and derivatives more holistically. A holistic perspective may lead to a different and more targeted approach to revising auditing standards to address any identified problems. For example, the Fair Value Paper is silent on how any proposed changes in auditing standards would impact the auditor's assessment of materiality. Perhaps new guidance would be usefully targeted on these assessments in the context of auditing estimates and fair value measurements. Auditing standards on the use of specialists represent another potential area for targeted revisions in auditing guidance. Moreover, while we recognize that the PCAOB expects auditors to understand pricing models used by management, more clarity is needed in certain areas as to the PCAOB's expectations (including under current auditing standards), such as on auditors' responsibilities with respect to internal controls of pricing services and modelers. Further examination may also be necessary to distinguish between data providers and specialists and what role they play in the audit.

3. Hedging and Derivative Activities

Fair value measurements are important for businesses and their investors. Hedging and derivative operations are also an important means of businesses to mitigate risk, as well as lock in prices and secure raw materials needed to produce goods for the market and to provide stable pricing mechanisms for the benefit of consumers. Nevertheless, fair value valuation, hedging and derivatives are all very different functions and, again, it is unclear why the PCAOB wants to create one standard for all these along with accounting estimates. This seems to fail to appreciate the heterogeneous nature of the transactions and events in these areas and would seem to unnecessarily increase complexity in auditing and may have severe unintended consequences for businesses and their investors.

Further, hedging and derivatives activities have and continue to undergo significant regulatory changes since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). With these activities not yet completed it would seem that revising auditing standards in those areas also may be premature.

We strongly recommend that the PCAOB work with other regulatory bodies including the SEC, Commodity Futures and Trading Commission, and the Federal Reserve Bank in order to harmonize policy work.

4. Business Advisory Group

Writing to the PCAOB on a different issue, on February 23, 2012, FIRCA proposed that a Business Advisory Group be established.[8] FIRCA believes that standard setters should have a wide range of input to ensure the proper consideration of business operations and potential unintended consequences in the development and implementation of accounting and auditing standards. We expressed concerns that a lack of broad based input may cause the PCAOB to expend resources that may be best allocated elsewhere, while developing auditing standards that do not adequately recognize and appreciate financial reporting structures to convey decision useful information to investors or businesses.

We believe that this is a case in point. It is unclear what the exact issues the PCAOB is concerned with or what issues it is trying to resolve. Indeed, had a Business Advisory Group been in existence in 2009-2010, the PCAOB would have had a ready forum to discuss concerns with fair value and to obtain information beneficial to assist the inspections and standard setting process. This could have provided the PCAOB with a better understanding of economic conditions and the implications for the development of auditing standards that contribute to reliable

[8] *See* February 23, 2012 letter from FIRCA to PCAOB Chairman Doty on the issue of mandatory audit firm rotation.

decision useful information for investors. Indeed, it may have helped the PCAOB take action quicker and in a more informed manner.

We would request that the PCAOB explore this proposal.

5. Use of the Term Deficiency

The Fair Value Paper makes repeated use of the term deficiency and we would hope that the PCAOB can provide some clarity around the definition and usage of this term, particularly since it appears the PCAOB is using it in a different manner over the past few months than it has over the past several years.

The 2010 PCAOB Report states:

> [t]he discussion in this report of any audit deficiency reflects information reported to the Board by the inspection team and are not a result of an adversarial adjudicative process and do not constitute conclusive findings of fact or of violations for purposes of imposing legal liability.

Using these parameters, a deficiency is not a conclusive finding of fact or a violation. In fact, under this usage the term deficiency can reflect a difference in the exercise in judgment or analysis. However, starting in 2011, the PCAOB began to refer to Part I inspection deficiencies as audit failures, which is much different than the manner in which the term was used in the 2010 PCAOB Report. The manner and usage of the term audit failures with respect to Part I inspection deficiency findings is contrary to the accepted definition of an audit failure.

For instance, the definition of audit employed by the General Accounting Office in its 2003 surveys ("GAO Report") and report to Congress on the mandatory audit firm rotation concept.

The GAO report defined the term as follows:

> "audit failure" refers to audits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the

> relevant facts and circumstances would have concluded that the audit was not conducted in accordance with GAAS, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.

Under the GAO a pre-condition for an audit failure is a material misstatement of the financial statements, presumably one that would trigger a restatement.

It would appear that the 2010 PCAOB report, 2013 PCAOB report, and the Fair Value Paper each use the term deficiency in different ways and it is unclear how commenters can evaluate facts and conclusions in these reports without a clear understanding as to how deficiency and audit failure are used, especially in the context of fair value measurements. A lack of precision in language in different reports again makes it difficult for stakeholders to provide informed commentary on the Fair Value Paper.

Conclusion

Thank you again for the opportunity to comment on the Fair Value Paper. FIRCA would respectfully request that the public be given more information, as discussed in this letter, to better understand if there is a problem and what, if any, advisable course of action that would be appropriate. We would also request that auditing derivatives and hedging not be a part of this project and that the PCAOB work with the relevant regulatory bodies to determine what if any activities should take place in those areas. Finally, we would respectfully request the creation of a business advisory group to facilitate an efficient standard setting process.

We stand ready to work with you on these issues and are happy to discuss our concerns and thoughts in greater detail.

Sincerely,

American Council of Life Insurers
Barnert Global, Inc.
CRE Finance Council
Independent Community Bankers of America
Mortgage Bankers Association
National Association of Real Estate Investment Trusts
The Real Estate Roundtable
U.S. Chamber of Commerce