Auditing Estimates and Fair Values: Investor Perspectives & Related Considerations

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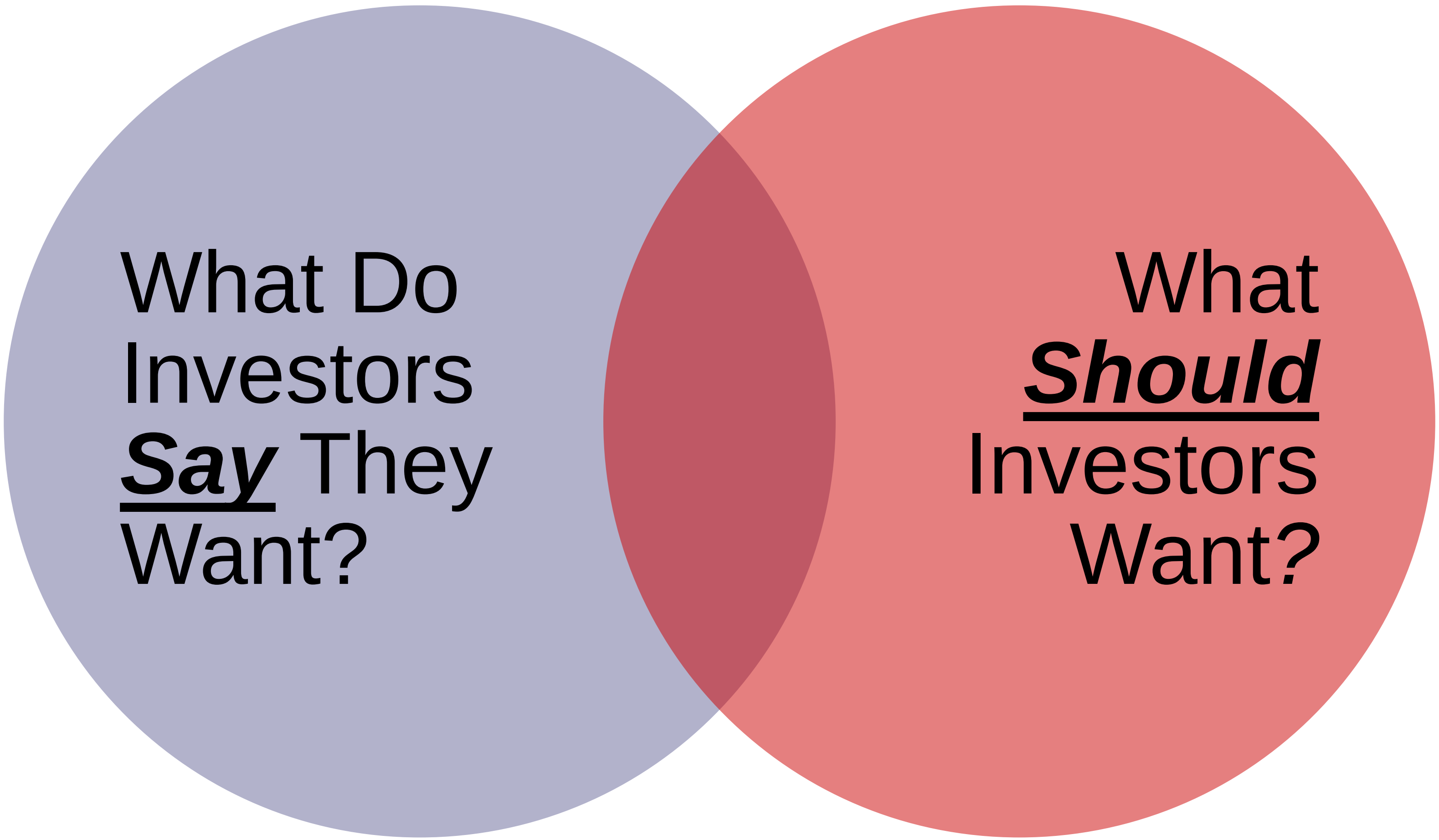
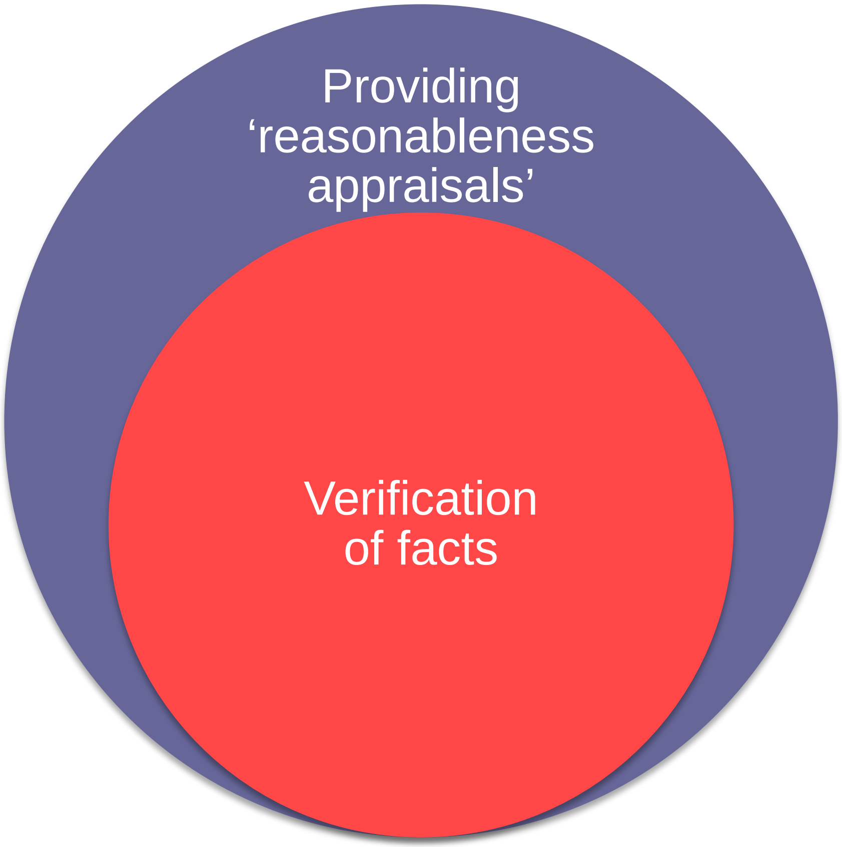
A perspective on investors' perspectives

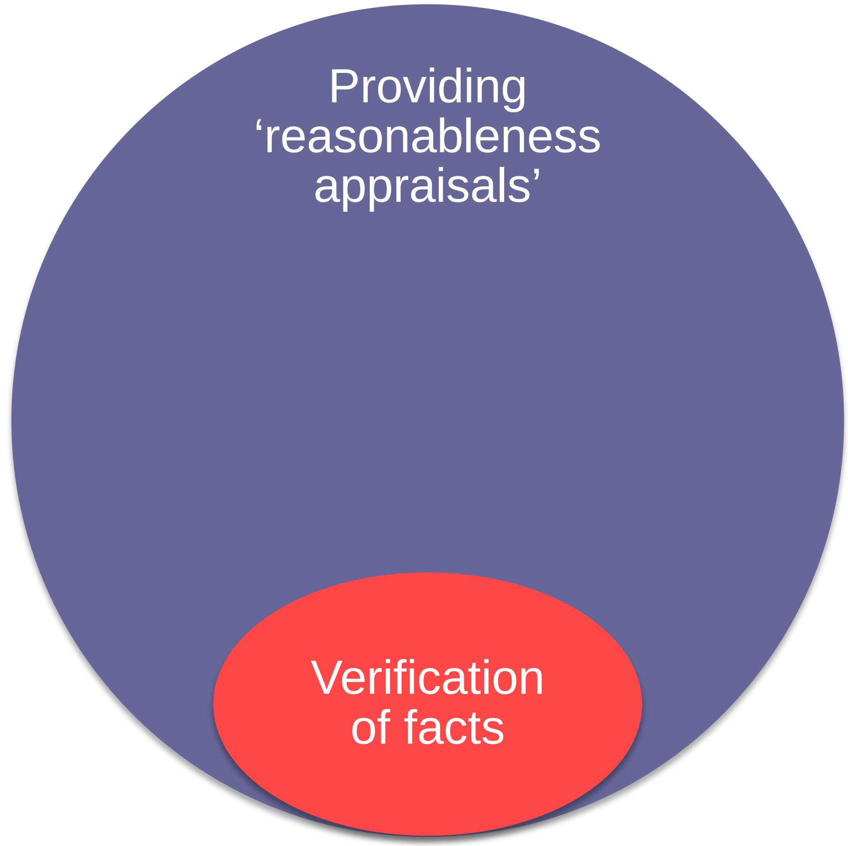


A perspective on risk of an “audit failure”

<u>circa 1934</u>



<u>Now</u>



Should investors want this to be a rule of an engagement?

AU § 342.03

"***Management is responsible for making the accounting estimates included in the financial statements.*** Estimates are based on subjective as well as objective factors and, as a result, ***judgment*** is required to estimate an amount at the date of the financial statements. Management's judgment is ***normally*** based on its knowledge and experience about past and current events and ***its assumptions about conditions it expects to exist and courses of action <u>it expects to take</u>***." [emphasis supplied]

Investors should be concerned because…

- Even though *facts* that management purports to consider are *verifiable*, subjective components are *unknowable,* i.e., not verifiable.
- Consequently, auditors are limited to evaluating whether management has an "appropriate" basis for its estimate
  - When the present doesn't look much like the past, this can be a big problem.
  - Also, it is how earnings management takes place

Evidence from an auditor

I’ve got scars on my back from when I … told my clients that they could not manage earnings. My clients went to the Board of Directors of the firm and said***, “get Walter off my account—just get him off.”***

Earnings management was rampant … It was like dirt; it was everywhere and I think it’s still everywhere ***because the accounting standards that we have today still allow management to have control of the numbers***.

The allowance for doubtful accounts—management controls that number. … The liability for claims - management controls that number. There are all sorts of numbers in the financial statements that are controlled by management ***and the auditors don’t have any foothold to go to management and say no, that number is wrong.***

“Interview with Walter Schuetze,” SEC Historical Society, February 14, 2006. [emphasis added]

Paths forward

-And/Or-

More of the same:

- Intensify inspection and enforcement
- Improve guidance

Evolve the rule of engagement

Starting the evolution

- Initial Scope
  - Large financial institutions
  - Financial assets for which Level II or III fair values are required by U.S. GAAP
- Procedure
  - Independent appraisals
  - Auditor responsible for *verifying*:
    - Factual information provided by management is accurate
    - Appraiser meets specific independence requirements
    - Appraiser performed the work it was supposed to
    - Appraiser's calculations were accurate

A thought experiment

*Could an independent appraisal of **all** assets liberate audit practice?*

- Focus on traditional core competence — verification
  - Little or no audit risk of being “second guessed”
  - U.S. GAAP would be much less complex

Acknowledgement

- Schuetze, Walter. "Auditing: Objective Evidence vs. Subjective Judgments," speech to Foundation for Accounting Education, New York State Society of CPAs, September 9, 2003.

- Available at: http://bit.ly/1p4dRzh