Thomas I. Selling PhD, CPA
4718 E. Rancho Dr.
Phoenix, AZ 85018
Tom.Selling@GroveSite.com

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Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: Staff Consultation Paper No. 2015-01 – The Auditor's Use of the Work of Specialists

Dear PCAOB Board and Staff Members:

In October 2014, the PCAOB convened a special meeting of its Standing Advisory Group (SAG) for a series of panel discussions based on the August 2014 SCP, *Auditing Accounting Estimates and Fair Value Measurements.* I was on the panel discussing investor perspectives.

The issues addressed in SCP 2015-01 on the work of specialists overlaps significantly with the August 2014 SCP, since specialists are typically engaged to produce estimates. I will provide specific comments related to the use of specialists, beginning with general comments and recommendations that apply equally to both SCPs. I respectfully request that the Board consider my comments when deliberating both SCPs.

My comments are organized as follows: I begin with evidence to support the view that fundamental reform is called for with regard to producing and auditing estimates. After describing the fundamental reform I have in mind for producing and auditing estimates, I provide specific recommendations concerning the use of specialists.

The Critical Role of Management's Estimates in Financial Reporting

Estimates are pervasive throughout financial statements. They are in the economic lives of buildings and machinery, the loan loss allowances of banks on their loans to Greece, and practically everything else in between. Yet, these estimates are fundamentally flawed for three reasons:

1. A basic deficiency in financial reporting is that every estimate is produced by management, or specialists who are (usually) not independent from management. Although management will not always undertake to produce biased estimates, it is generally conceded that incentives often exist for management to personally benefit by producing biased estimates.

2. Existing PCAOB standards on auditing estimates produced by management or non-independent specialists do not require auditors to fully correct management bias. They are only expected to provide reasonable assurance that the estimates are within a "reasonable" range.

3. Too many estimates are unauditable for too many reasons. For example: they are based on management intent, which auditors have little incentive or basis to question; or circumstances have changed to the point where recent trends are not predictive of the future.

The purposes of the following examples is to show how pervasive and ingrained the problem of management estimates has become in financial reporting:

- Jack Welch, former CEO of General Electric Co. (GE) and an iconic management thought leader, included the following vignette in his memoirs:

  > "The response of our business leaders to the [earnings] crisis was typical of the GE *culture*. Even though the books had closed on the quarter, many immediately offered to pitch in to cover the Kidder gap. Some said they could find an extra $10 million, $20 million, and even $30 million from their businesses to offset the surprise. Though it was too late, their willingness to help was a dramatic contrast to the excuses I had been hearing from the Kidder people." [1] [emphasis added]

  Mr. Welch has stunningly revealed, without any apparent sense of impropriety, that financial statement manipulation was an honorable management activity at one of the iconic U.S. public corporations. He evidently required his subordinates to fill their own accounting "cookie jars" with accounting reserves, and as team players they were expected to share them. It is also worth noting that GE has retained the same audit firm for the last 105 years. One could speculate as to how forcefully the current partner-in-charge of the GE account would push back against the current CEO's accounting estimates in a similar scenario — and risk losing GE as a client for the firm.

- If only to confirm that Mr. Welch is not alone in his view of financial reporting, Walter Schuetze, former SEC's chief accountant and a charter member of the FASB, provided this characterization of his experiences as an auditor:

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

[1] Welch, Jack (2003), *Straight from the Gut,* Warner Books, p. 225.

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** … **and the auditors don't have any foothold to go to management and say no, that number is wrong.***"[2] [emphasis supplied]

- The New York Times columnist on economic policy matters, Nobel laureate Paul Krugman, rarely writes on financial reporting matters, but in one he writes with unconcealed frustration following the Financial Crisis of 2008:

  "So here's what Mr. Summers [Secretary of the Treasury] — and, to be fair, just about everyone in a policy-making position at the time — believed in 1999: America has honest corporate accounting; this lets investors make good decisions, and also forces management to behave responsibly; and the result is a stable, well-functioning financial system.

  What percentage of all this turned out to be true? ***Zero***." [emphasis supplied]

- In October 2010, the European Commission asked how, given the large losses recently recognized, auditors could have justified clean opinions on the reports of numerous banks from 2007 to 2009. It is far from clear that any of the long-delayed proposals for additional management estimates, or enhanced auditing standards can make significant improvements. Yet, if anything, unchecked management bias is becoming more prevalent in critical areas such as loan loss allowances by large financial institutions.

- In April 2014, the International Forum of Independent Audit Regulators expressed grave concern for the numerous deficiencies involving the examination of estimates.

- In October 2014, the PCAOB reported that of 23 audits inspected for a major international auditing firm, 65% were completed without obtaining sufficient information to support its opinion.

- The comment letter on this SCP from the Institute of Management Accountants, which purports to express a "corporate point of view," states as follows:

  "There is too much of an implication [in the SCP] that management will always try to bias its financial reporting so that auditors have to be extra sensitive to this 'bias.'" (p. 3)

  Notwithstanding, a 2015 survey, conducted by the Institute of Internal Auditors Research Foundation, of 500 North American audit executives found that

[2] SEC Historical Society Interview with Walter Schuetze, available at: http://tinyurl.com/oa5ls9w

incidences of management exerting undue influence on financial reporting is pervasive. Specifically, 55% of the survey participants had been directed to change or ignore results of their investigations. Many had been threatened either physically or with being fired, while others suffered cuts in internal audit staff and budgets as part of concerted efforts to neutralize them. In addition, 49% of those surveyed reported their managers or executives directed them to avoid high-risk areas of the business.[3]

- In a recent speech, SEC Commissioner Kara Stein opined that financial reporting had not "…worked ideally in the financial crisis, and neither [US GAAP or IFRS] may service investors well in today's post-financial crisis."[4]

- Profit and loss for the largest and most systemically important financial institutions can depend almost entirely on managements' estimates of loan loss allowances and their valuations of non-traded derivative financial insitutions. Throughout history, many have expressed concern that the financial disclosures of large financial institutions opaque, misleading and contribute to the frequency and severity of economic crises. For recent and prominent examples, I encourage you to read *The Bankers' New Clothes: What's Wrong With Banking and What to Do About It* (Anat Admati and Martin Helwig).

- Former Enron CFO and convicted fraudster, Andy Fastow, recently stated at a conference of the Association of Certified Fraud Examiners:

    > "I wasn't the chief finance officer at Enron, I was the chief loophole officer …. [I]n my opinion, the problem today is *10 times worse* than when Enron had its implosion … The things that Enron did, and that I did, are being done today, and in many cases they're being done in such a manner that makes me blush — and I was the CFO of Enron." [emphasis supplied]

  He cited the continuing widespread use of off-balance-sheet vehicles, as well as inflated financial assumptions embedded in corporate pension plans.[5]

The Basic Deficiency in PCAOB Standards

The longstanding basis for the relationship between management estimates and the audit engagement is currently set forth in AU § 342.03 of the PCAOB's interim standards (AU 328 contains similar language concerning auditing fair values), which states, in relevant part, as follows:

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[3] WSJ blog available at http://blogs.wsj.com/cfo/2015/03/11/internal-auditors-face-pressure-over-results-survey-says/

[4] Available at http://www.sec.gov/news/speech/2015-spch032615kms.html.

[5] As reported by Fortune.com, available at http://fortune.com/2013/07/01/the-confessions-of-andy-fastow/.

> "*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 it expects to take*."
>
> The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole…." [emphasis supplied]

This longstanding rule of auditing, which vests the right to determine financial statement values — subject to a vague constraint of "reasonableness" — has no direct basis in the securities laws. And, what management chooses to consider when forming its judgments is a matter of management judgment itself. *The PCAOB inherited this language from the AICPA, and the PCAOB should change it.*

Even under ideal circumstances, assessing the "reasonableness" of management's estimates, or seriously contesting management's stated intent to take future actions, poses formidable challenges to audit quality. Indeed, history has repeatedly demonstrated that when facts and circumstances indicate to any extent that the past is not predictive of the future, no auditor — not matter how technically qualified or independent — could competently assess the "reasonableness" of management's (or a specialist's) estimates.

A Proposal for Fundamental Change

In essence, an audit can be seen to compromise two distinct services: (1) verification of *facts,* and (2) providing assurance that the *subjective* estimates made by management are "reasonable." Perhaps the greatest regulatory success story post-Enron is how the PCAOB, and regulators in other jurisdictions following its lead, have used inspections to document the recurrence of alarmingly high rates of audit deficiencies from *failure to adequately examine management's estimates*. And, by the absence of cases, the inspections have provided a strong indication that auditors are satisfactorily performing their duties as verifiers of fact.

Decades of experience should have taught us that merely incremental change to the language of AU Sections 328, 336 or 342 will not have an appreciable effect on audit quality, and recent evidence supports fundamental change toward verification focused audits. A promising point of departure toward would be to change the way that the fair values of financial instruments of Systemically Important Financial Institutions (i.e., those subject to supervision by the Federal Reserve Board and to prudential standards under the Dodd-Frank Act) are measured and audited. For the financial instruments where fair values are *not* derived from quoted prices in active markets for identical financial instruments (so-called "Level I" fair values per

U.S. GAAP), management should be required to engage independent appraisal specialists to estimate the fair values. Consistent with a verification focus, the auditor would be called upon to verify key facts, such as the following:

- The factual information provided by management to the appraiser is accurate and complete.
- The appraiser possesses the necessary professional qualifications.
- The appraiser meets specific independence standards.
- The appraiser's measurements comply with U.S. GAAP and their engagement letter with the issuer.
- The appraiser's calculations are free from error.

Even if only the incremental step of focusing on fair value estimates by SIFIs were implemented, that would be substantial progress, indeed! But looking further ahead, more pervasive use of independent estimates would diminish issuer preferences for judgment-based accounting — since they would no longer be able to control how those judgments are made. Appraisal specialists will, as always, prefer to make their inferences from arm's-length transactions, and from there it is not difficult to envision that resistance from issuers to the use of market prices for measuring assets will steadily diminish.

Following my presentation at the SAG meeting, much of the ensuing discussion was devoted to concerns with the reliability of independent appraisals. For this reason, Bo Nordlund and I reviewed existing research on this and related questions. Our forthcoming paper is attached.[6]

In brief, we found that:

- Independent appraisals would not be a radical change from current practice when auditing fair value estimates. The larger audit firms have teams of specialists that are capable of performing the independent appraisal function. Perhaps, even, an appropriately isolated group within the audit firm could perform appraisal work that would ultimately become the numbers in the financial statements of the audit client.

- While challenges to appraiser independence can exist, they are similar to auditor independence. Like auditors, the ethical standards of the appraisal profession require the appraiser to inoculate itself from improper client involvement in its work. Individual state regulatory agencies are responsible for licensing appraisers, investigating complaints and taking appropriate disciplinary action.

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[6] Thomas I. Selling and Bo Nordlund, "The Problem of Management Bias in Accounting Estimates: An Investor Perspective on Root Causes and Solutions, *Business Horizons,* forthcoming.

- Estimation uncertainty in measuring current values does not differ dramatically from other types of estimates. Researchers have estimated uncertainty in property valuations, and the overall findings are not out of range of the perceived overall uncertainty in financial reporting.

Specific Comments on SCP 2015-01

The principles I describe on the use of appraisal specialists for producing estimates of fair values extends naturally to the general use of specialists employed by either management or the auditor.

SCP 2015-01 states, "A company's specialist might be influenced by the same factors that may cause bias in other personnel of the company who are involved in preparing the company's financial statements." (p. 22) Accordingly, the auditor's responsibilities to test estimates should be limited *only* if a specialist is independent of management. Consistent with the logical basis for independence and the evident intent of the securities laws, any other relationship between management and a specialist should not alter the responsibilities of either the auditor or management.

But, if a specialist is independent from management, then management need not be held responsible for the estimates produced by the specialist. The auditor's responsibilities would be limited to the verification functions that I outlined earlier:

- To verify that the specialist possesses the qualifications to perform the engagement, and complies with rules of independence set forth either by the PCAOB or the SEC.

- To verify, on a test basis, inputs that are capable of verification and to test that calculations are free from error.

With respect to the independence standards used for specialists, I believe that either the PCAOB or SEC should promulgate independence requirements for specialists using the existing standards for auditors (Article 2 of Reg. S-X) as a starting point.

* * * * *

U.S. GAAP is becoming more complex, and in the process it is becoming even more susceptible to estimation bias by management, who are given strong economic incentives to manifest their biases.

Even in stable times, management bias produces unjustified and embarassing wealth transfers from investors to management. There is also still strong justification for the view that inadequate financial reporting regulations will be a significant contributor to a next financial crisis. At minimum, the PCAOB's own inspection evidence suggests that existing PCAOB standards governing auditing of

management estimates contributes to perceptions that auditors lack independence from their clients and/or fail to exercise due professional care.

If the responsibility for financial statement judgments were transferred to independent appraisers and specialists, auditing could become solely a verification service. Auditors would benefit, and financial statements would better serve investors and the public interest in a stable economy.

Sincerely,