

## Investor Perspectives & Related Considerations on Auditing Estimates and Fair Value Measurements: Remarks at the Meeting of the Standing Advisory Group of the Public Company Accounting Oversight Board

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### Introduction

Good morning. Thank you for the invitation to appear on this panel.

As a representative of institutional investors, I am concerned about the Public Company Accounting Oversight Board's ("PCAOB") observation in the Staff Consultation Paper that there are "significant audit deficiencies" in audits of accounting estimates and fair value measurements.<sup>1</sup> My concern is heightened by at least two factors.

### Fair Value Accounting

First, I believe fair value accounting with robust disclosures provides investors with more useful information than amounts that would be reported under amortized cost or other alternative accounting approaches. In 2008, during the height of the financial crisis, the Council of Institutional Investors ("Council") commissioned a white paper to educate our members, policymakers and the general public about fair value accounting and its potential impact on investors.<sup>2</sup>

The white paper, issued in July of 2008, was authored by Stephen G. Ryan, KPMG faculty fellow, professor of accounting, and director of the accounting doctoral program, at the Leonard N. Stern School of Business at New York University.<sup>3</sup> In that paper, Professor Ryan concluded that fair value accounting benefits investors for a variety of reasons:

It requires or permits companies to report amounts that are more accurate, timely, and comparable than the amounts that would be reported under existing alternative accounting approaches, even during extreme market conditions;

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<sup>1</sup> Public Company Accounting Oversight Board, Staff Consultation Paper, Auditing Accounting Estimates and Fair Value Measurements 3 (Aug. 19, 2014), [http://pcaobus.org/Standards/Documents/SCP\\_Auditing\\_Accounting\\_Estimates\\_Fair\\_Value\\_Measurements.pdf](http://pcaobus.org/Standards/Documents/SCP_Auditing_Accounting_Estimates_Fair_Value_Measurements.pdf).

<sup>2</sup> Stephen G. Ryan, Fair Value Accounting: Understanding the Issues Raised by the Credit Crunch (July 2008), [http://www.cii.org/files/publications/white\\_papers/07\\_11\\_08\\_fair\\_value\\_accounting.pdf](http://www.cii.org/files/publications/white_papers/07_11_08_fair_value_accounting.pdf).

<sup>3</sup> *Id.*

It requires or permits companies to report amounts that are updated on a regular and ongoing basis;

It can limit companies' ability to manipulate their net income because gains and losses on assets are reported in the period they occur, not when they are realized as the result of a transaction; and

Gains and losses resulting from changes in fair value estimates indicate real economic events that companies and investors often find worthy of additional disclosures and other information.<sup>4</sup>

In October of 2008, following the release of the white paper, the Council issued a joint statement with the CFA Institute and the Center for Audit Quality.<sup>5</sup> The statement opposed efforts under way at the time by financial institutions and their allies to force the U.S. Securities and Exchange Commission ("SEC") to suspend the use of fair value accounting for certain companies.<sup>6</sup>

The joint statement generally adopted the views contained in the Council white paper and concluded that "[s]uspending fair value accounting during these challenging times would deprive investors of critical financial information when it is needed most."<sup>7</sup> In the years since the statement was issued, the Council's position on fair value accounting has not changed.

## Testing and Evaluation of Accounting Estimates

A second factor that heightens my concern about the significant audit deficiencies that the PCAOB staff has identified is that investors appear to assign a high value to the auditor's testing and evaluation of accounting estimates. I believe that view is demonstrated by the broad support the PCAOB has received from investors for pursuing improvements to the auditor's report that would include the auditor's assessments or insights on management's critical accounting estimates and judgments.<sup>8</sup>

For example, 79 percent of institutional investors responding to a survey by the PCAOB's own Investor Advisory Group expressed the belief that the auditor's report should discuss the auditor's assessment of the accuracy of management's "significant estimates and judgments."<sup>9</sup>

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<sup>4</sup> *Id.* at 1.

<sup>5</sup> Press Release, Joint Statement of the Center for Audit Quality, The Council of Institutional Investors and The CFA Institute Opposing Suspension of Mark-to-Market Accounting 1 (Oct. 1, 2008), <http://www.thecaq.org/newsroom/2008/10/01/joint-statement-of-the-center-for-audit-quality-the-council-of-institutional-investors-and-the-cfa-institute-opposing-suspension-of-mark-to-market-accounting>.

<sup>6</sup> See, e.g., Arthur Levitt, Jr. & Lynn Turner, Op-Ed., *How to Restore Trust in Wall Street*, Wall St. J., Sept. 26, 2008, at 1, <http://online.wsj.com/articles/SB122238715655877159>.

<sup>7</sup> Press Release at 1.

<sup>8</sup> See, e.g., Proposed Auditing Standards, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, PCAOB Release No. 2013-005, at 14 (Aug. 13, 2013), [http://pcaobus.org/Rules/Rulemaking/Docket034/Release\\_2013-005\\_ARM.pdf](http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf).

<sup>9</sup> Investor Advisory Group, Improving the Auditor's Report 20 (Mar. 16, 2011), [http://pcaobus.org/News/Events/Documents/03162011\\_IAGMeeting/Role\\_Of\\_The\\_Auditor.pdf](http://pcaobus.org/News/Events/Documents/03162011_IAGMeeting/Role_Of_The_Auditor.pdf).

As an aside, I would note that KPMG UK's recent auditor's report for Rolls-Royce Holdings is generally responsive to that investor demand.<sup>10</sup> I remain hopeful that over time the auditing profession in the United States will come to realize that it is in its best interest, financial and otherwise, to improve the auditor's report in a like manner.

## Conclusion

For the reasons stated, if it is the PCAOB's judgment that significant audit deficiencies identified in the staff paper can be reduced by improving the standards relating to auditing accounting estimates and fair value measurements, I am confident that many, if not most, institutional investors would support such a project.

Finally, I would like to conclude my prepared remarks by commenting on my fellow panelist Thomas I. Selling's interesting recommendation on experimenting with "an independent appraisal of all assets . . ."<sup>11</sup> On that topic, I would just echo the concerns raised by former SEC Chief Accountant Paul Beswick.

Chief Accountant Beswick, on more than one occasion, expressed the view that the ability of the valuation industry to fully serve auditors and investors is inhibited by the industry's inability to-date to become a true profession.<sup>12</sup> More specifically, he suggested that, as a starting point, the valuation industry should establish a single set of qualifications with respect to:

- Education level and work experience,
- Continuing education,
- Standards of practice and ethics, and
- A code of conduct.<sup>13</sup>

With that final comment, thank you again for inviting me to participate on this panel and for your kind attention.

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<sup>10</sup> Rolls-Royce Holdings plc, Annual Report 130 & 132 (2013), [http://www.rolls-royce.com/reports/2013/assets/pdf/RR\\_Full%20Annual%20Report\\_smallest.pdf](http://www.rolls-royce.com/reports/2013/assets/pdf/RR_Full%20Annual%20Report_smallest.pdf); see, e.g., Floyd Norris, *Holding Auditors Accountable on Reports* 1-5, N.Y. Times, May 8, 2014, at 1-5, [http://www.nytimes.com/2014/05/09/business/holding-auditors-accountable.html?\\_r=0](http://www.nytimes.com/2014/05/09/business/holding-auditors-accountable.html?_r=0).

<sup>11</sup> Thomas I. Selling, *Auditing Estimates and Fair Values: Investor Perspectives & Related Considerations* 9 (Oct. 2, 2014), [http://pcaobus.org/News/Events/Documents/10022014\\_SAG/Selling\\_Slides.pdf](http://pcaobus.org/News/Events/Documents/10022014_SAG/Selling_Slides.pdf).

<sup>12</sup> See Paul Beswick, Chief Accountant, Office of Chief Accountant, U.S. Securities and Exchange Commission, Remarks at the AICPA 2013 Conference on Current SEC and PCAOB Developments 3 (Dec. 9, 2013), [http://www.sec.gov/News/Speech/Detail/Speech/1370540488257#.VDLjc\\_ldW7w](http://www.sec.gov/News/Speech/Detail/Speech/1370540488257#.VDLjc_ldW7w); Paul A. Beswick, Deputy Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission, Prepared Remarks for the 2011 AICPA National Conference on SEC and PCAOB Developments 5 (Dec. 5, 2011), <http://www.sec.gov/news/speech/2011/spch120511pab.htm> [hereinafter Beswick 2011 Speech].

<sup>13</sup> Beswick 2011 Speech, *supra* note 12, at 5.