American Bankers Association
Building Success. Together.

Michael L. Gullette
Vice President – Accounting and Financial Management
202-663-4986
mgullette@aba.com

August 1, 2017

International Auditing and Assurance Standards Board
Via website submission: www.iaasb.org

Re: Proposed International Standard on Auditing 540 (Revised) – *Auditing Accounting Estimates and Related Disclosures*

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on the Proposed International Standard on Auditing 540 (Revised) – *Auditing Accounting Estimates and Related Disclosures* (the Proposal). Accounting estimates are pervasive throughout bank financial statements, mainly through the allowance for loan and lease losses (ALLL) and the fair value measurement of various financial assets and liabilities. While IAASB standards technically do not apply to U.S. companies, we believe that only in rare occasions will the Auditing Standards Board of the American Institute of CPAs (ASB) approve auditing standards for non-SEC registrants that are significantly different from the IAASB. With the Accounting Standards Updates (ASUs) recently issued by the Financial Accounting Standards Board (FASB) that will change how loan fair values are disclosed and how credit losses are measured[2], it is easy to see that the Proposal will have a significant impact on audits of many non-SEC registrant banking institutions.

We believe the concurrently outstanding proposal issued by the Public Company Accounting Oversight Board (PCAOB) largely conforms to the spirit of this Proposal, while perhaps providing more prescriptive guidance related to the auditing of management assumptions.[3] As such, we believe that certain aspects of the PCAOB proposal will be used to understand how specific procedures may address certain objectives noted in this Proposal. With those things in mind, we are also attaching our response to the PCAOB proposal, as we believe our comments therein have relevance to this Proposal. The comments included here are specific to this Proposal.

## Steps to Address Professional Skepticism Will be Ineffective

The Proposal stresses the need for professional skepticism during audits, emphasizing the need to "stand back" and evaluate whether sufficient appropriate audit evidence (SAAE) has been

---

[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.

[2] FASB Accounting Standards Updates 2016-1 (*Recognition and Measurement of Financial Assets and Financial Liabilities*) and 2016-13 (*Measurement of Credit Losses on Financial Instruments* – also known as "the CECL Standard").

[3] See PCAOB Release No. 2017-002 *Proposed Auditing Standard – Auditing Accounting Estimates, Including Fair Value Measurements*.

obtained and that management's decisions relating to recognition, measurement, presentation, and disclosure are in accordance with the accounting framework. While this appears to be a sound step in the overall audit process, we are confused as to how such a process is different from current auditing processes relating to other issues or of the audit process as a whole. If "standing back" merely formalizes what is already performed (and would be expected in any audit), ABA questions the overall benefit of codifying such a process. While ABA generally welcomes professional skepticism in the audit process, without more detail as to how such a process is conducted, it is difficult to see how such guidance will improve audits.

The Proposal also discusses professional skepticism in the light of addressing management bias in accounting estimates. This seems reasonable for fair value estimates, as the estimates made are meant to reflect market-based (and not management-based) assumptions. However, subjectivity and bias are inherent features of the CECL standard (as well as IFRS 9). True, expected credit loss assumptions are meant to be "reasonable and supportable." However, both FASB and U.S. banking regulators acknowledge the expectation that different banks will have different views of the future[4] – "bias" is an integral part of these expected credit loss accounting standards.

There may be the notion that the auditor can detect bias that is considered unreasonable. However, due to the non-linear relationship of economic forecasts to credit losses (for example, there are often no credit losses on collateral-based loans until a specific loan-to-value ratio is reached), small differences in forecasted macroeconomic factors can often have a large impact on the reported financial performance. Unreasonable bias will often be very difficult to detect. By the design of these accounting standards, there will be no practical way to reduce management bias in these estimates.

## The Auditing Requirements will be Costly

We believe the upcoming implementation of IFRS 9 and the CECL standard, in light of the requirements in the Proposal relating to obtaining and evaluating sufficient audit evidence over the complexity, judgments, and estimation uncertainty of the ALLL, will require significantly more supporting documentation from the bank and more industry expertise on the part of the auditor. This will be costly to banks, especially at the community bank level, where auditors may need to hire valuation and credit risk specialists to evaluate whether these highly judgmental assumptions are considered "reasonable." In light of the IAASB's observation that, if the auditor decides to perform an independent estimate, its range for the estimate "may be multiples of materiality for the financial statements", it is very difficult to see how the value of such additional audit requirements will exceed the costs. With such estimation uncertainty, users of financial statements will get little comfort from the more stringent documentation requirements, especially in times of economic stress, when significant skepticism over any assumptions of the

[4] In addition to different views of the future, banks will have different thresholds as to when (as it applies to IFRS 9) deterioration in credit quality is considered significant, and different judgments as to the quantitative impact of those factors. Banks will even differ on assumed borrower behavior and specific factors that are considered when evaluating credit risk.

future would be expected. This is not necessarily a defect in the proposed auditing standard, but is the nature of the related accounting standards.

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

August 1, 2017

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

Via website submission: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 043: Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements*

To Whom It May Concern:

The American Bankers Association (ABA[5]) appreciates the opportunity to comment on the Proposed Auditing Standard – *Auditing Accounting Estimates, Including Fair Value Measurements* (the Proposal). Accounting estimates and fair value measurements are pervasive throughout bank financial statements, mainly through the allowance for loan and lease losses (ALLL) and the measurement of other financial assets and liabilities. While PCAOB standards technically apply only to audits of public companies, for practical purposes, the proposed revisions will likely be considered interpretations of current and future standards of audits related to non-public companies, as the Proposal is largely consistent with the concurrently outstanding proposal issued by the International Auditing and Assurance Standards Board (IAASB) to address international auditing standards.[6] We have attached our comments to the IAASB proposal as an Appendix.

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 – addressed in a related proposal[7] – are often used by banks of all sizes in generating such estimates. With the Accounting Standards Updates (ASUs) recently issued by the Financial Accounting Standards Board (FASB) that will change how loan fair values are disclosed and

[5] 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.

[6] See IAASB Proposed International Standard on Auditing 540 *Auditing Accounting Estimates and Related Disclosures (Revised)*. http://www.ifac.org/publications-resources/proposed-international-standard-auditing-540-revised-auditing-accounting. We believe the Auditing Standards Board of the American Institute of CPAs, which sets auditing standards for non-public companies in the U.S., will largely adopt the IAASB proposal without significant modification.

[7] PCAOB Release No. 2017-003 *Proposed Amendments to Auditing Standards for Auditor's Use of The Work of Specialists*.

how credit losses are measured[8], it is easy to see that the Proposal will have a significant impact on audits of banking institutions.

**The Costs of the Proposal Exceed its Benefits, Due to Upcoming Accounting Standards**

The Proposal appears to attempt to codify the increasingly extensive documentation that auditors of large banks have required over the past few years – in response to PCAOB inspections – to support the quantitative assumptions made by management in their accounting estimates. The Proposal also stresses the need for professional skepticism during audits. For example, terms such as "corroborate" are replaced by "evaluate" and "compare" in order for the auditor to challenge any potential bias in management's judgments. The intent behind these aspects of the Proposal seems understandable. However, if approved, the requirements of the Proposal will result in significantly higher audit costs and, possibly, the end of the ability of many local auditing firms to audit community banks. Worse, however, it will do so with no significant improvement to auditing of the most significant balance on most bank balance sheets – the allowance for loan and lease losses (ALLL). In other words, the costs of the expanded documentation and audit responsibilities will exceed its benefits.

The Proposal notes that one of the main benefits of the proposed standard will be from a capital market perspective:

> "An increase in investors' confidence about the information provided in companies' financial statements resulting from improved audit quality can increase the efficiency of capital allocation decisions"

We generally agree with the statement. However, any declines in investor confidence in bank financial statements have not been the result of insufficient auditor scrutiny, but rather because highly judgmental estimates of the fair value of financial instruments and the ALLL are made during times of illiquid markets and intense economic uncertainty. The assumptions, and their quantitative impacts, will always be subject to intense skepticism and no auditing standard will increase investor confidence in the assumptions made during these times.[9] Going forward, however, with the CECL standard's requirement to forecast the depth and timing of such future economic uncertainty, there will likely be nothing an auditor can do to increase investor confidence in such estimates *at any point in the economic cycle*. With that in mind, the main benefits cited in the Proposal are highly questionable.

We believe the upcoming implementation of ASU 2016-1 (specifically related to the requirement of disclosing the fair value of loans at "exit price") and the CECL standard, in light of the requirements in the Proposal relating to scrutiny of management's assumptions, will require significantly more supporting documentation from the bank and more industry expertise on the

---

[8] FASB Accounting Standards Updates 2016-1 (*Recognition and Measurement of Financial Assets and Financial Liabilities*) and 2016-13 (*Measurement of Credit Losses on Financial Instruments* – also known as "the CECL Standard").

[9] ASU 2016-13 acknowledges that "estimating expected credit losses is highly judgmental" and the nature of estimating credit losses is subjective.

part of the auditor. This will be costly to banks, especially at the community bank level, where auditors may need to hire valuation and credit risk specialists to determine whether the highly judgmental assumptions are "reasonable." In light of the IAASB's observation in their proposed revision to International Standard on Auditing 540 that, if the auditor decides to perform an independent estimate, its range for the estimate "may be multiples of materiality for the financial statements", it is very difficult to see the value that such a specialist brings to a bank investor. As a result, the PCAOB must recognize that the costs of the Proposal will be borne by many smaller banks that may have to hire larger auditing firms.

**The Final Standard Must Recognize that Bias is Inherent to CECL**

A significant portion of the Proposal discusses professional skepticism and the elimination of management bias in accounting estimates.[10] This seems reasonable for fair value estimates, as the estimates made are supposedly based on market-based assumptions. However, subjectivity and bias are inherent features of the CECL standard. True, CECL assumptions are meant to be "reasonable and supportable" and there may be the notion that the auditor can detect bias that is considered unreasonable. However, due to the non-linear relationship of economic forecasts to credit losses (for example, there are often no credit losses on collateral-based loans until a specific loan-to-value ratio is reached), small differences in forecasted macroeconomic factors can often have a large impact on the reported financial performance. Unreasonable bias will often be very difficult to detect. By the design of the CECL standard, there will be no practical way to reduce management bias in a way that brings investor confidence in the financial statements.

Designing and testing an internal control system intended to eliminate bias in such an environment will include quarterly analysis of which assumptions are (and are not) significant in each estimate. For example, as consideration of prepayments is required within CECL, short-term movement of interest rates can sometimes be a significant assumption, and sometimes not. More significantly, however, is that for practical purposes, the Proposal effectively requires a bank to perform a sensitivity analysis of its significant assumptions to change, based on other reasonably likely outcomes that would have a material effect.[11] While this sensitivity test can be performed in many ways, ABA believes it is likely it will include probability weighting–a process specifically omitted from the CECL standard – as a sign of an effective internal control system. Without probability weighting, it is difficult to see how sensitivity testing will address management bias.[12]

---

[10] Per paragraph .09: "…performing procedures…to form a conclusion about whether the estimate is reasonable…and free from bias that results in material misstatement." Paragraph .30 and .31 then requires specific evaluation of bias.

[11] Per paragraph .18, "the auditor should obtain an understanding of how management analyzed the sensitivity…"

[12] ABA acknowledges that management bias will still exist within the weighting. However, auditors may believe that reviewing the weighting in a more detailed fashion may enable an auditor to more efficiently evaluate levels of bias.

A further difficulty in the attempt to eliminate bias is the requirement in paragraph .64 of the proposed amendments to *AS 2301, The Auditor's Responses to the Risks of Material Misstatement* to effectively back-test the estimates. While model back-testing is a standard practice in the banking industry, doing so to ensure the elimination of management bias is not. Backtesting for this purpose appears to effectively require banks to apply macroeconomic "market views" when forecasting the future. Such a requirement appears to contradict the intent of FASB in codifying the forecasts of the future into the CECL estimate. In discussions ABA has conducted with FASB members, banking agency personnel, and auditing firms, backtesting was foreseen to be performed on specific components of the model (for example, a default rate given a specific forecasted macroeconomic assumption) but not the total model (which would include the accuracy of the macroeconomic assumption). It was assumed that the macroeconomic assumption would always contain inaccuracies.

As a whole, the Proposal appears to commingle legitimate auditing concerns relating to management bias of certain fair value estimates with those that are inherent to the CECL estimate. CECL's management-based forecast of the future is, by design, highly subjective and efforts to eliminate its subjectivity and bias will be futile. As a result, ABA recommends that guidance related to reducing management bias not apply to the CECL standard. Guidance on how an auditor assesses the reasonableness of assumptions and their quantitative impacts, including the evaluation of related internal controls, may better serve the auditor of the ALLL.

**The Final Standard Must Recognize the Work of Industry Regulators**

Banking agency examinations are critical aspects of ALLL and fair value estimation processes for banks. For all practical purposes, we believe that the perspectives of the bank regulatory 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. In many situations, regulatory bank examiners provide guidance to banks on ALLL assumptions and may even qualify as specialists in their review of the ALLL and of other issues regarding financial instruments. With this in mind, we recommend that PCAOB specifically and explicitly address the work of regulatory examiners in assessing the reasonableness of management assumptions.

**The Final Standard Must Clarify the Definition of "Methods"**

Use of specific valuation methods are common practice within fair value measurements. However, as various methods and models may emphasize different aspects of credit risk, estimating credit losses normally involves a combination of various methods in order to arrive at a final ALLL balance. For example, a credit loss estimate under CECL can involve using a vintage loss rate method, supplemented by analyses of credit rating migration and estimated loan-to-value ratios; both of which may equate to roll rate and probability of default/loss given default "methods". In practice, quarterly estimation processes can be fluid, with different weight given to the different analyses over time, due to various circumstances. Other further supplemental analyses may provide further adjustments and, in some cases, the baseline estimate may not make up the majority of final amount. Based on the bank, the processes can be different and change by product, subsidiary, geographic region, etc.

Paragraph .11 of the Proposal requires auditors, if the company has changed the method for determining the accounting estimate, to determine the reasons for such change and to evaluate the appropriateness of the change. Under such a requirement, onerous documentation requirements await bankers to support why (or why not) a change in method is appropriate. We do not believe this is the intent of the PCAOB. However, without further clarification, we believe such requirements will be understood. Therefore, the final standard should clarify the difference between methods and analyses, as well as provide guidance on how auditors and bankers can interpret when a change in method occurs in a fluid environment, such as credit risk analysis.

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