1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202)862-8430
www.pcaobus.org

STANDING ADVISORY GROUP MEETING

AUDITING FAIR VALUE

SEPTEMBER 8-9, 2004

Introduction

The Standing Advisory Group ("SAG") will discuss issues associated with auditing the measurement and disclosure of assets and liabilities at fair value. This briefing paper covers issues related to current auditing literature and auditing procedures used to obtain evidence about fair value measurements and disclosures required by current accounting standards. The Financial Accounting Standards Board (FASB) is developing new guidance on fair value measurements and disclosures and has issued an exposure draft (ED). The Appendix briefly summarizes the ED.

The comment deadline for the ED is September 7, 2004 and the proposed statement would be effective for financial statements issued for fiscal years beginning after June 15, 2005, and interim periods within those fiscal years. Earlier application would be encouraged. On September 21, 2004, FASB will hold a public roundtable meeting with respondents to the ED to obtain additional input. FASB plans to issue the final standard in the first quarter of 2005. This briefing paper deals with auditing the current requirements. The PCAOB will be working with FASB and the Securities and Exchange Commission on changes in auditing methods and audit reporting that might be appropriate when the final standard is issued.

Auditing Standards and Other Audit Guidance

Many fair value measurements result from approximations, rather than exact measures, and involve numerous estimates, classifications, judgments, and allocations. This issue is not unique to fair value measurements. Indeed, many other areas in accounting involve estimating management's ability and intent and also subjectivity and uncertainty. An audit enhances confidence that an entity used objectivity in making the approximations and did not make the approximations with the intent of creating a biased presentation of the financial statements. In addition, an audit can enhance the usefulness of accounting information by improving the three qualities of relevance, reliability, and comparability. However, the financial audit's greatest contribution to enhancing the quality of accounting information relates to providing assurance that that the accounting information is reliable.

When auditing a fair value measurement or disclosure, the auditor must obtain evidence about various aspects of the measurement or disclosure. The auditor must first understand what is being measured or disclosed and then evaluate whether management has applied the appropriate accounting principles, which includes application of appropriate valuation methods and the determination of the necessary disclosures. If the company is using a model, rather than observable market data, the auditor should determine that market inputs have been used to the extent possible and that the inputs are reasonable. This evaluation generally will satisfy the auditor's obligation to consider the relevance, neutrality and representational faithfulness of the measurement or disclosure.

A financial statement audit should reduce management's bias toward accounting measures, including fair value measurements, that result in an accounting outcome that is most favorable to management. An auditor can directly verify the reliability of some accounting measures, such as by substantiating the cost of land or securities acquired. An auditor can also verify the procedures used to obtain a measure, such as by substantiating that management has used the present value of future cash flows as a method for measuring fair value. Direct verification of an accounting measure tends to minimize management bias and the risk that the measurement will be misstated. However, in general, verification of the procedures used to obtain the measure only reduces the risk of management bias.

As the variability of the fair value measurements increases, which results in less precise measurement, there generally is less evidence available to the auditor to verify that management has made an appropriate estimate of fair value. For example, it is difficult to verify the reliability of a fair value measurement that incorporates management's expectations about future developments because management's expectations are not observable. However the maximum use of market based inputs in developing assumptions reduces the reliance on entity-specific assumptions. In the audits of Enron, the terms of the energy contract transactions were outside observable market conditions and the auditor's judgments about the propriety of management's assumptions were not successful in reducing the risk of management bias.

There are many existing accounting standards (40 such FASB and Accounting Principles Board pronouncements) that address fair value accounting measurements. Fair value measurements are required for a variety of assets and liabilities on the balance sheet, such as investments in securities, derivative financial instruments, goodwill and other intangibles, impaired long-lived assets, certain financial instruments with aspects of liabilities and equity, asset retirement obligations, pension and post-retirement obligations, guarantees, and also in the consolidation of variable-interest entities. Therefore, auditors have a significant responsibility to effectively audit the fair value measurements found in current financial statements.

Considerations Associated with Current Auditing Standards and Other Guidance

This section of the briefing paper addresses auditing considerations described in Statements on Auditing Standards ("SAS") and certain other publications that provide additional procedures for the auditor's consideration.

SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), requires the auditor to obtain sufficient competent audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. Generally accepted accounting principles express a preference for measuring fair value based on observable market prices. However, in the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.

Paragraph 9 of SAS No. 101 requires the auditor to obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach. The auditor should consider, among other things, the significant management assumptions used in determining fair value, the documentation supporting management's assumptions, and the process used to develop management assumptions, including whether management used available market information to develop the assumptions.

Paragraph 17 of that standard states that the auditor should evaluate management's intent and ability to carry out specific courses of action where intent is relevant to the use of fair value measurement, the related presentation and disclosure requirements, and the reporting of changes in fair value. Paragraph 17 of SAS No. 101

also notes that the auditor's procedures "ordinarily include" inquiries of management, with appropriate corroboration of responses, by:

- Considering management's history of carrying out its stated intentions with respect to assets and liabilities
- Reviewing written plans and other documentation, including budgets, minutes, and other such items
- Considering management's stated reasons for choosing a particular course of action
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including implications of contractual commitments.

SAS No. 101 provides numerous illustrations of auditing procedures the auditor may use to verify fair value measures, most of which are not required.

In addition to SAS No. 101, the AICPA Audit and Accounting Guides and Audit Risk Alerts deal in general with fair value issues of the broker-dealer, investment company, and insurance industries.

Discussion Questions –

1. In the circumstances described in SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), are the suggested means of corroboration of management's intent adequate? If not, what other means of corroboration should the auditor employ?
2. Does there come a point when the auditor may be unable to verify management's intent? If so, what auditing alternatives are available in these circumstances?

Paragraph 18 of SAS No. 101 requires that when there are no observable market prices and the entity estimates fair value using a valuation method, the auditor should evaluate whether the entity's method of measurement is appropriate in the circumstances. This involves obtaining understanding of management's rationale for selecting a particular method by discussing with management its reasons for selecting the valuation method. The "auditor considers whether":

- Management has sufficiently evaluated and appropriately applied the criteria, if any, provided by GAAP to support the selected method

- The valuation method is appropriate in the circumstances given the nature of the item being valued

- The valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.

Paragraph 23 of SAS No. 101 requires the auditor, based on the risk of material misstatement, to test the entity's fair value measurements and disclosures. In addition, "…substantive tests of the fair value measurement may involve (a) testing management's significant assumptions, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions."

Paragraph 33 of the standard states that the auditor should focus attention on the significant assumptions that management has identified. Generally, significant assumptions cover matters that materially affect the fair value measurement and may include those that are –

a) Sensitive to variation or uncertainty in amount or nature. For example, assumptions about short-term interest rates may be less susceptible to significant variation compared to assumptions about long-term interest rates.

b) Susceptible to misapplication or bias.

Discussion Questions –

3. Paragraph 33 of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), describes a "significant assumption" in general terms and provides an example of an assumption that may be considered significant (in the category "sensitive to variation or uncertainty in amount or nature"). The standard does not provide an example in the category "susceptible to misapplication or bias." How usable is the concept of "significant assumption" from an audit standpoint?

4. Should the auditing standard provide a more comprehensive and detailed description of a significant assumption? Should the definition include

more examples in the two categories? Should there be more categories of significant assumptions? If so, what categories would be beneficial to add?

Paragraph 34 of SAS No. 101 notes

The auditor considers the sensitivity of the valuation to significant changes in assumptions, including market conditions that may affect the value. Where applicable, the auditor encourages management to use techniques such as sensitivity analysis to help identify particularly sensitive assumptions. If management has not identified particularly sensitive assumptions, the auditor considers whether to employ techniques to identify those assumptions.

Discussion Questions –

5. Paragraph 34 of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), imposes a conditional responsibility on the auditor that if management "has not identified particularly significant assumptions the auditor considers whether to employ techniques to identify those assumptions." Should there be a requirement in the auditing standard that the auditor identify significant assumptions, regardless of whether management identifies them?

6. Because of the material effects on fair value measurements that small changes in significant assumptions can cause when an entity uses a valuation model, should auditors be required to evaluate the effects on the measurements of changes in assumptions?

7. Are there particular assumptions or types of assumptions that might be most sensitive to variation or uncertainty or susceptible to management misapplication, bias, or fraud?

Paragraph 38 of SAS No. 101 addresses items valued by the entity using a valuation model and says that "the auditor reviews the model and evaluates whether the assumptions used are reasonable and the model is appropriate considering the entity's circumstances."

STANDING ADVISORY GROUP MEETING

Discussion Questions –

8. Is it sufficiently clear as to what is meant by the statement that the auditor "reviews the model"? How could this directive be clarified?

9. Should the auditor evaluate the assumptions used based on what market participants would use, or may the auditor base the evaluation solely on information internal to the company being audited?

Paragraph 39 of SAS No. 101 offers auditing procedures for testing data used to develop fair value measurements and to evaluate the propriety:

> The auditor should test the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. Specifically, the auditor evaluates whether the data on which the fair value measurements are based, including the data used in the work of a specialist, is accurate, complete, and relevant; and whether fair value measurements have been properly determined using such data and management's assumptions. The auditor's tests also may include, for example, procedures such as verifying the source of the data, mathematical recomputation of inputs, and reviewing of information for internal consistency, including whether such information is consistent with management's intent and ability to carry out specific courses of action discussed in paragraph 17.

Paragraph 40 of SAS No. 101 provides that the auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement. In addition, instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements.

In addition, paragraph 40 of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU sec. 332), states that the auditor should obtain evidence supporting management's assertions about fair value that were determined using a model by performing procedures such as "calculating the value, for example using a model developed by the auditor or by a specialist engaged by the auditor, to develop an independent expectation to corroborate the reasonableness of the value calculated by the entity."

STANDING ADVISORY GROUP MEETING

Paragraphs 44 and 45 of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), address the auditing of disclosures about fair value. Paragraph 44 of that standard requires that the auditor obtain "sufficient competent audit evidence that the valuation principles are appropriate under GAAP and are being consistently applied, and that the method of estimation and significant assumptions used are adequately disclosed in accordance with GAAP." Paragraph 45 of the standard goes on to state that the "auditor evaluates whether the entity has made adequate disclosures about fair value information. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty."

Discussion Questions –

10. Paragraph 40 of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), provides procedures that auditors may use to evaluate whether management has properly determined its fair value measurements. Should the auditing standard require the auditor to perform those procedures? Are there additional procedures that the auditor should perform?

11. Paragraphs 40 of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU sec. 332), and SAS No. 101 provide that auditors may make an independent estimate of fair value, but do not require it. Should there be a requirement that auditors, or specialists working under the direction of the auditors, be required to develop a model to develop an independent expectation of the reasonableness of management's fair value measurement?

12. Should the auditing standard provide more specific guidance for evaluating management's compliance with the existing fair value disclosure requirements?

Other Publications That Address Fair Value Measurements. Many of the other publications that address fair value measurements suggest auditing procedures that could be useful for verifying management's valuations. For example, the Audit and Accounting Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities,* provides guidance on how an auditor should audit a Black-Scholes-derived model. Paragraph 6.29 provides the following guidance

STANDING ADVISORY GROUP MEETING

Determine how sensitive the estimate of fair value is to changes in volatility. Ask the entity to run the model several times using different volatility rates while all other variables are held constant. This will indicate how sensitive the estimate is to assumptions about volatility. Evaluate the results of this test in light of materiality. For example, if large changes in the volatility rate do not produce a material impact on the financial statements, the auditor may be able to reduce audit risk to an acceptable level with a minimum of other test work.

The Audit Risk Alert, *Insurance Industry Developments,* addresses the capitalization and valuation of mortgage servicing rights, which is a fair value measurement requirement of FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Paragraphs 79 through 82 highlight "common pitfalls to look for in reviewing initial capitalization." Similarly, paragraphs 83 through 88 highlight "common pitfalls to look for in reviewing impairment valuations." These series of paragraphs describe areas where entities purportedly frequently misapply the provisions of FASB statement No. 140. Examples include:

.80 Failure *to properly perform the relative fair-value allocation*. In accordance with FASB Statement No. 140, servicing assets retained in a sale should be initially measured by allocating the previous carrying amount between the loans sold and the mortgage-servicing rights retained, based on their relative fair values at the date of sale. Often, an institution will misinterpret or shortcut this step. The typical shortcut involves recording the mortgage-servicing rights at fair value without performing an allocation. Failure to perform the relative fair-value allocation will usually result in the overcapitalization of the mortgage-servicing rights.

.84 *Failure to properly evaluate impairment at the strata level.* An entity should have stratified its mortgage-servicing rights in accordance with the guidelines set forth in FASB Statement No. 140. The auditor needs to evaluate the impairment calculation to determine whether the institution stratified its mortgage-servicing rights and evaluated for impairment at the strata level. The risk exists that the institution may just assess impairment by comparing total book value of all mortgage-servicing rights against the total market value for the entire portfolio. This would result in a netting effect of any stratum with cushions against stratum with impairment, and is clearly prohibited in FASB Statement No. 140.

STANDING ADVISORY GROUP MEETING

Discussion Question –

13. Should the Board include the auditing procedures found in these other publications in an auditing standard on auditing fair values?

Using the Work of a Specialist. Due to the number of complexities that can be associated with applying the fair value measurement requirements of GAAP for financial and non-financial assets and liabilities, there may be a need for auditors to use the work of a person or firm with a special skill or knowledge in these areas. Paragraph 20 of SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AU sec. 328), states:

> The auditor should consider whether to engage a specialist and use the work of that specialist as evidential matter in performing substantive tests to evaluate material financial statement assertions. The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or may decide to use the work of a specialist. If the use of such a specialist is planned, the auditor should consider the guidance in Section 336, *Using the Work of a Specialist*.

Paragraph 6 of SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AU sec. 332), provides:

> The auditor may plan to seek the assistance of employees of the auditor's firm, or others outside the firm, with the necessary skill or knowledge. Section 311, *Planning and Supervision*, provides guidance on the use of individuals who serve as members of the audit team and assist the auditor in planning and performing auditing procedures. The auditor also may plan to use the work of a specialist. Section 336, *Using the Work of a Specialist*, provides guidance on the use of the work of specialists as evidential matter.

SAS No. 73, *Using the Work of a Specialist* (AU sec. 336) is applicable when an auditor uses the work of a specialist in a financial statement audit. The standard defines a specialist as "a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing." SAS No. 73 applies, but is not limited, to actuaries, appraisers, engineers, environmental consultants, and geologists. Paragraph 3 provides that the guidance is applicable when:

a) Management engages or employs a specialist and the auditor uses that specialist's work as evidential matter[1/] in performing substantive tests to evaluate material financial statement assertions.

b) The auditor engages a specialist and uses that specialist's work as evidential matter in performing substantive tests to evaluate material financial statement assertions.

The auditor has a duty to evaluate the professional qualifications of the specialist in order to determine whether the specialist possesses the necessary skill or knowledge in the particular field. The auditor should consider the professional certification, license, or other recognition of competence of the specialist in his or her field; the reputation and standing of the specialist; and the specialist's experience in the type of work under consideration. The auditor also should obtain an understanding of the nature of the work performed, or to be performed, by the specialist. This understanding includes the objectives and scope of the specialist's work and the specialist's relationship to the client.

The auditor is required to evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. These circumstances include situations in which the client has the ability, through employment, contractual right, family relationship, or other means, to directly or indirectly control or significantly influence the specialist. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

Paragraph 12 of SAS No. 73 notes that –

> the appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (*a*) obtain an understanding of the methods and assumptions used by the specialist, (*b*) make appropriate tests of data provided to the specialist, taking into account

---

[1/] Under section 201 of the Sarbanes-Oxley Act of 2002, it is unlawful for a registered public accounting firm that performs a financial statement audit of a public company to also perform appraisal or valuation services for that company.

the auditor's assessment of control risk, and (*c*) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

Discussion Question –

14. Given the critical nature, sensitivity, and susceptibility to management bias or fraud of assumptions, especially concerning models where there is no observable market data, if a valuation specialist has to be used, should that specialist be engaged by the auditor and supervised in the same manner and to the same extent as other members of the engagement team?

STANDING ADVISORY GROUP MEETING

APPENDIX

FASB Exposure Draft on Fair Value

In June 2004, FASB issued an exposure draft ("ED") of the proposed accounting standard, *Fair Value Measurements.* The proposed standard clarifies that the objective of a fair value measurement is to "estimate an exchange price for the asset or liability being measured in the absence of an actual transaction for that asset or liability." The ED provides guidance on how to measure fair value, with the intent of improving financial reporting as a result of increased consistency, reliability, and comparability. The proposed standard applies to financial and nonfinancial assets and liabilities that are measured at fair value under existing accounting pronouncements and also provides guidelines for interim and annual disclosures.

The exposure draft also included the present value guidance in FASB Concepts Statement No. 7, *Using Cash Flow Information and Present Value in Accounting Measurements* (CON 7), as updated by the ED, thus elevating that guidance to Level A GAAP (generally accepted accounting principles), which is the most authoritative level. Paragraphs C10 and C11 of the ED noted:

> The Board remains committed to achieving its long-term objective of measuring all financial instruments at fair value, but not until all related issues are resolved…Specifically, this Statement establishes a framework that builds on current practice and requirements, clarifying the fair value measurement objective and its application under other pronouncements that require fair value measurements…

The ED clarified the definition of fair value as "the price at which an asset or liability could be exchanged in a current transaction between knowledgeable, unrelated willing parties." Willing parties are presumed to be unrelated marketplace participants having a common level of understanding about factors relevant to the asset or liability and are willing and able to transact in the same market. Fair value presumes the absence of compulsion or duress, i.e., the amount estimated would not be observed in a forced liquidation or distress sale.

The proposed standard also clarified that the "unit of account" specified in other pronouncements should be used in estimating fair value. If the unit of account is not specified, than it may be determined based on available market inputs. An example of a unit of account would be an individual security. The fair value would be the product of

STANDING ADVISORY GROUP MEETING

the quoted price times the quantity held. The ED does not change the existing guidance from AICPA Audit and Accounting Guides[2/] on large positions of securities held by broker-dealers and certain investment companies. Those industries are permitted to estimate fair value, in limited circumstances, using an adjustment to the quoted prices (known as a blockage factor). In these cases, the unit of account is a block. FASB plans to address this inconsistency related to broker dealers and certain investment companies in its separate financial instruments project.

The ED also established a hierarchy of levels for estimating fair values:

a) *Level 1 estimates.* Estimate fair value using quoted prices for identical assets or liabilities in active reference markets whenever that information is available.

b) *Level 2 estimates.* If quoted prices for identical assets or liabilities in active markets are not available, estimate fair value using quoted prices for similar assets or liabilities in active markets, adjusted for differences, when that information is available.

c) *Level 3 estimates.* If quoted prices for identical or similar assets or liabilities in active markets are not available, or if differences between similar assets or liabilities are not objectively determinable, estimate fair value using multiple valuation techniques consistent with the market approach, income approach, and cost approach whenever the information necessary to apply those techniques is available without undue cost and effort.

The Level 3 income approach uses valuation techniques to convert future amounts (e.g., cash flows) to a single present discounted amount, based on the value indicated by marketplace expectations about future amounts. The ED notes that those valuation techniques include present value techniques and option-pricing models such as Black-Scholes-Merton and lattice models, which incorporate present value.

The ED requires that a fair value estimate using present value should capture the following elements that taken together would make up the price at which an asset or

---

[2/] Audit and Accounting Guide-*Broker-Dealers* and Audit and Accounting Guide *Investment Companies* liability could be exchanged in a transaction between knowledgeable, unrelated willing parties:

a) Estimate of future cash flows

b) Possible variations in the amount or timing of the cash flows

c) Price for bearing the uncertainty inherent in the cash flows

d) Time value of money, represented by the risk-free interest rate

e) Other case-specific factors, such as liquidity and market imperfections

f) For liabilities, the effect of an entity's creditworthiness.

Appendix C of the ED notes that users of financial statements generally have agreed that fair value information is relevant. However, others have expressed concerns about the reliability of measurement in the absence of quoted market prices. Reliability encompasses neutrality, verifiability, and representational faithfulness, and, according to Appendix C, is not intended to denote certainty or precision. Appendix C also notes that the reliability of estimates depends on the inputs used and, therefore, an entity should use as many market inputs are as available and about which there is consensus in order to replicate an exchange price for the asset or liability.

However, FASB acknowledged in Appendix C, as it did in CON 7, that in some cases relevant market inputs for assets and liabilities that are not exchanged in active markets might not be available without undue cost and effort, requiring the use of significant entity inputs. Paragraph 38 of CON 7 explained:

> …an entity that uses cash flows in accounting measurements often has little or no information about some or all of the assumptions that marketplace participants would use in assessing the fair value of an asset or liability. In those situations, the entity must necessarily use information that is available without undue cost and effort in developing cash flow estimates. The use of an entity's own assumptions about future cash flows is compatible with an estimate of fair value, as long as there is no contrary data indicating that marketplace participants would use different assumptions. If such data exist, the entity must adjust its assumptions to incorporate that market information.

STANDING ADVISORY GROUP MEETING

*   *   *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.