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## STANDING ADVISORY GROUP MEETING

### EMERGING ISSUE – AUDIT CONSIDERATIONS IN THE CURRENT ECONOMIC ENVIRONMENT

OCTOBER 22 - 23, 2008

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#### Introduction

At the October 2008 meeting of the Standing Advisory Group ("SAG"), members of the SAG will be asked to provide their views on how the current economic environment affects the risk of material misstatement of financial statements, and, as a result, auditors' upcoming audits of financial institutions and other entities. SAG members also will be asked whether the PCAOB should issue additional guidance to assist auditors in their upcoming audits.

#### Possible Considerations in Upcoming Audits

The PCAOB's auditing and related professional practice standards provide direction to auditors in a variety of areas that may be relevant to audits in the current economic environment. These areas include auditing fair value and other accounting estimates, assessing a company's ability to continue as a going concern, and evaluating financial statement disclosures.<sup>1/</sup> Depending on the circumstances of a particular audit, certain of these areas may require heightened emphasis, such as:<sup>2/</sup>

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<sup>1/</sup> See AU sec. 328, *Auditing Fair Value Measurements and Disclosures*; AU sec. 332, *Auditing Derivative Instruments*; AU sec. 342, *Auditing Accounting Estimates*; AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*; and AU sec. 431, *Adequacy of Disclosures in Financial Statements*.

<sup>2/</sup> In discussing audit issues that may arise in the current environment, this paper necessarily describes relevant generally accepted

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

- *Fair value measurements* – Difficulties surrounding the measurement of fair value in times of market distress and the adequacy of related disclosures have come under increased focus over the past year. Statement of Financial Accounting Standard ("FAS") No. 157<sup>3/</sup> revised the way in which fair values are determined for financial reporting purposes and the disclosures that should be made about those measurements.

On December 10, 2007, the PCAOB staff issued Staff Audit Practice Alert No. 2 ("Practice Alert"), *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*.<sup>4/</sup> The Practice Alert reminds auditors of their responsibilities under AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, when auditing fair value measurements, including evaluating classifications within the fair value hierarchy and valuations provided by a pricing service. The Practice Alert also reminds auditors of their responsibilities under AU sec. 336, *Using the Work of a Specialist*, when using a specialist to assist in the audit of fair value measurements of

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accounting principles ("GAAP") used by public companies. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the U.S. Securities and Exchange Commission. Accordingly, while this paper describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

<sup>3/</sup> In September 2006, the Financial Accounting Standards Board ("FASB") issued FAS 157, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The FASB deferred the implementation of FAS 157 for certain nonrecurring, nonfinancial assets and liabilities for financial statements issued for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years. The standard, which some companies early-adopted, defines fair value, establishes a framework for measuring fair value, and expands disclosures.

<sup>4/</sup> Practice Alert No. 2 can be found at [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/2007/12-10\\_APA\\_2.pdf](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2007/12-10_APA_2.pdf).

financial instruments. (The Practice Alert is attached as Appendix A.)

On September 30, 2008, staff from the U.S. Securities and Exchange Commission ("SEC") Office of the Chief Accountant and the Financial Accounting Standards Board ("FASB") issued "Staff Clarifications on Fair Value Accounting" (attached as Appendix B) acknowledging that "[t]he current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors and users of financial information."<sup>5/</sup> Additionally, on October 10, 2008, the FASB issued FSP FAS157-3: *Determining Fair Value in a Market That Is Not Active*, to clarify the application of FAS 157 in a market that is not active and provide an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.<sup>6/</sup> (FSP FAS 157-3 is attached as Appendix C.)

- *Other than temporary impairment* – In accordance with FAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, a charge to earnings should be made for impairment that is "other than temporary" in held-to-maturity and available-for-sale securities. SEC Staff Accounting Bulletin ("SAB") No. 59, *Accounting for Noncurrent Marketable Equity Securities*, also provides direction regarding "other than temporary" and indicates that "other than temporary" should not be interpreted to mean "permanent." SAB No. 59 further provides that "[u]nless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded." Additionally, under FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets*, certain beneficial interests should be written down to fair value through earnings if the security has declined below its cost and there has been an adverse change in the estimated cash flows. There are a variety of considerations with respect to other than temporary impairments, such as intent and ability to hold to recovery, anticipated recovery period, and quantifying an impairment.

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<sup>5/</sup> See <http://www.sec.gov/news/press/2008/2008-234.htm>.

<sup>6/</sup> See [http://www.fasb.org/pdf/fsp\\_fas157-3.pdf](http://www.fasb.org/pdf/fsp_fas157-3.pdf).

- *Credit derivatives* – Credit derivatives are highly engineered and depend (by definition) on the value of other instruments or events. Credit derivatives may be valued through the use of complex models or the use of pricing specialists. The assumptions used in models can be highly subjective; a slight difference in assumptions could result in significant valuation discrepancies. Another factor to consider in evaluating credit derivatives is counterparty credit risk, which represents the possibility that a counterparty defaults on a transaction, in this case an over-the-counter derivative. This risk can be assessed in part by the credit rating of the counterparty, or the cost of a credit default swap on the counterparty. In many cases, hedge funds (which are very active in the credit derivative market) are not rated, and are required to post collateral with their counterparties on any out-of-the money positions. In September 2008, the FASB issued a staff position aimed at improving disclosures about credit derivatives.<sup>7/</sup>
- *Going concern* – On October 9, 2008, the FASB issued an exposure draft for a Proposed Statement of Financial Accounting Standards on going concern.<sup>8/</sup> The proposed statement would provide guidance on the preparation of financial statements as a going concern. It also would require certain disclosures when either the financial statements are not prepared on a going concern basis or when there is substantial doubt as to an entity's ability to continue as a going concern. Currently, AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, contains the requirements about the going concern assessment. The FASB decided to carry forward the going concern requirements from AU sec. 341 subject to several modifications to align the requirements with International Financial Reporting Standards. One of those modifications is to change the time horizon for the going concern assessment. AU sec. 341 states that there is a "responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date

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<sup>7/</sup> FASB Staff Position No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161.*

<sup>8/</sup> See [http://www.fasb.org/draft/ed\\_going\\_concern.pdf](http://www.fasb.org/draft/ed_going_concern.pdf).

of the financial statements being audited."<sup>9/</sup> As described in the exposure draft, International Accounting Standard 1, *Presentation of Financial Statements*, requires that an entity consider "all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period" when assessing whether the going concern assumption is appropriate.<sup>10/</sup> The comment period deadline on the exposure draft is December 8, 2008.

- *Pensions/other postretirement benefits ("OPEB")* – The provisions of FAS 157 apply to the measurement and valuation of pension and OPEB plan assets in an employer's financial statements as well as the plan's separate financial statements. There are also several assumptions that are considered in determining an entity's pension obligation (such as discount rate, expected return on plan assets, and rate of compensation increase). The expected rate of return on plan assets is a particularly important element in the determination of pension expense. Further, many employee benefit plans are invested in illiquid investments that are at the heart of the current credit crisis, which will affect the financial statements of both the plans and their sponsors.
- *Receivables* – If companies are not collecting receivables at a faster rate than they are paying suppliers, they will need to consume valuable capital or turn to the equity/debt markets. In the current financial environment in which days sales outstanding (the amount of time receivables are outstanding) is increasing, there's a heightened risk of noncollection of receivables.<sup>11/</sup>
- *Inventory* – Higher levels of inventory in a company may indicate a greater risk of obsolescence, which could lead to write-downs, or discounting in order to move the inventory or maintain market share. Accounting Research Bulletin ("ARB") 43, *Restatement and Revision of Accounting Research Bulletins*, states that inventories

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<sup>9/</sup> See AU sec. 341.02.

<sup>10/</sup> See [http://www.fasb.org/draft/ed\\_going\\_concern.pdf](http://www.fasb.org/draft/ed_going_concern.pdf).

<sup>11/</sup> See August 24, 2008 article from Reuters, *Corporate America Taking Longer to Collect: Study*, at <http://www.reuters.com/article/reutersEdge/idUSN2745047620080827>.

should be valued at the lower of cost or market. A loss should be recognized whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes.<sup>12/</sup>

- *Other asset impairments* – Other asset valuations that have been and could continue to be affected include mortgages, consumer debt, business loans, goodwill, and long-lived assets, like property, plant and equipment and amortizable intangible assets.
- *Deferred taxes* – An environment in which a company is reporting losses or is exposed to future losses may indicate a need for a valuation reserve for deferred tax assets. FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, states that a "valuation allowance should be sufficient to reduce the deferred tax asset to the amount that is more likely than not to be realized."<sup>13/</sup>
- *Disclosures* – The volatility of the economic environment over the last year has resulted in increased attention to improving disclosures about the risks and uncertainties that issuers face. American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Risks and Uncertainties*, focuses on qualitative disclosures about risks and uncertainties that in the near term (considered to be within one year from the date of the financial statements) could affect the amounts reported in the financial statements or the functioning of the reporting entity. SOP 94-6 also requires disclosures for certain significant estimates and for current vulnerability arising because of specific concentrations.

### **Discussion Questions –**

This paper identifies the following areas which may require heightened audit emphasis in the current economic environment:

- Fair value measurements
- Other than temporary impairment

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<sup>12/</sup> See Chapter 4, paragraph 8, of ARB 43.

<sup>13/</sup> See paragraph 17e of FAS 109.



- Credit derivatives
  - Going concern
  - Pensions/other postretirement benefits
  - Receivables
  - Inventory
  - Other asset impairments
  - Deferred taxes
  - Disclosures
1. Do these areas present specific audit challenges in the current economic environment? Are there any additional areas relevant to consider?
  2. Which of the areas identified are likely to be most significant?

**Development of PCAOB Standards or Guidance**

On December 10, 2007, the PCAOB staff issued a Practice Alert to provide guidance related to auditing fair value measurements of financial instruments and the use of specialists. In 2008, the PCAOB Office of the Chief Auditor began a project to update the existing auditing standards on auditing accounting estimates, auditing fair value measurements and disclosures, and using the work of a specialist – all of which are pertinent to the audit of fair value measurements.

**Discussion Question –**

3. Should the PCAOB issue additional guidance to assist auditors in their upcoming audits? If so, what type of guidance would be helpful?

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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.

## **APPENDIX A**

### **PCAOB Staff Audit Practice Alert No. 2**

#### **MATTERS RELATED TO AUDITING FAIR VALUE MEASUREMENTS OF FINANCIAL INSTRUMENTS AND THE USE OF SPECIALISTS**

**December 10, 2007**



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## STAFF AUDIT PRACTICE ALERT NO. 2

### MATTERS RELATED TO AUDITING FAIR VALUE MEASUREMENTS OF FINANCIAL INSTRUMENTS AND THE USE OF SPECIALISTS

DECEMBER 10, 2007

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

The purpose of this staff audit practice alert is to remind auditors of their responsibilities for auditing fair value measurements of financial instruments and when using the work of specialists under the existing standards of the PCAOB. This alert is focused on specific matters that are likely to increase audit risk related to the fair value of financial instruments in a rapidly changing economic environment.<sup>1/</sup>

This practice alert highlights certain requirements in the auditing standards related to fair value measurements and disclosures in the financial statements and certain aspects of generally accepted accounting principles (GAAP) that are particularly relevant to the current economic environment.

While this practice alert focuses on fair value in general, it also draws the auditor's attention to certain areas of the new fair value accounting standard,

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<sup>1/</sup> A combination of factors in the housing and mortgage markets, including rising delinquency and default rates on subprime mortgages and declining home prices, has led to increases in actual and expected credit losses for residential mortgage-backed securities and mortgage loans. In early 2007, the credit markets began reacting to these changing factors and the prices of many securities backed by subprime mortgages began to decline. Lower volumes of transactions in certain types of collateralized securities might make it more difficult to obtain relevant market information to estimate the fair value of these financial instruments.

Statement of Financial Accounting Standard (SFAS) No. 157, *Fair Value Measurements*.<sup>2/</sup> Auditing fair value measurements developed under the new accounting standard likely will provide new challenges during implementation. Therefore, the practice alert describes the applicable accounting pronouncements in these areas and provides direction, in accordance with the auditing standards, for evaluating the application of GAAP.<sup>3/</sup>

The practice alert also discusses the auditor's responsibilities, under the existing auditing standards, when using the work of specialists. The alert provides some considerations for the auditor in determining whether a specialist is needed and highlights the requirement that the auditor should evaluate assumptions used in fair value measurements developed by a company's specialist in accordance with the PCAOB standard on auditing fair value measurements. It also highlights the auditor's responsibility to evaluate the appropriateness of using the specialist's work for the purpose of financial statements prepared in conformity with GAAP.

The practice alert is organized into four sections –

- Auditing fair value measurements;
- Classification within the fair value hierarchy under SFAS 157;
- Using the work of specialists; and

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<sup>2/</sup> In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS 157, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. This standard, which some companies early-adopted, defines fair value, establishes a framework for measuring fair value, and expands disclosures. On November 14, 2007, the FASB voted to expose for comment a one year deferral for the implementation of SFAS 157 for certain nonrecurring, nonfinancial assets and liabilities. See FASB web site at [www.fasb.org](http://www.fasb.org).

<sup>3/</sup> In order to provide guidance to auditors on auditing fair value measurements, this practice alert necessarily describes GAAP used by public companies to measure fair value. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the Securities and Exchange Commission. Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

- Use of a pricing service.

### **Auditing Fair Value Measurements**

AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, applies to auditing fair value measurements and disclosures in financial statements.<sup>4/</sup> Among other things, AU sec. 328 states that the auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. In general, for companies that had not adopted SFAS 157 before its mandatory effective date, GAAP in effect throughout 2007 provides that –

- Fair value is the amount at which an asset or liability could be bought or sold in a current transaction between willing parties, that is, other than a forced or liquidation sale;<sup>5/</sup>
- Quoted market prices in active markets are the best evidence of fair value and should be used as the basis for the measurement, if available;<sup>6/</sup>
- The estimate of fair value should consider prices for similar assets;<sup>7/</sup> and

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<sup>4/</sup> AU secs. 342, *Auditing Accounting Estimates*, and 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, also are related to auditing fair value.

<sup>5/</sup> See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, paragraph 69.

<sup>6/</sup> Ibid. Also, in paragraph 58 of SFAS 107, *Disclosures about Fair Value of Financial Assets* the FASB Board reiterated its belief that quoted prices, even from thin markets, provide useful information because investors and creditors regularly rely on those prices to make their decisions.

<sup>7/</sup> See SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*, paragraph 137; SFAS 133, *Accounting for Derivatives and Hedging Activities*, paragraph 540; and paragraph 69 of SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*.

- Valuation techniques should incorporate assumptions that market participants would use in their estimates of value.<sup>8/</sup>

In addition, AICPA Statement of Position (SOP) 94-6, *Disclosure of Certain Significant Risks and Uncertainties*, requires certain disclosures, in addition to those required by other accounting standards, about estimates when certain information is known prior to the issuance of financial statements.<sup>9/</sup>

SFAS 157 incorporates concepts similar to those in SFASs 115, *Accounting for Certain Investments in Debt and Equity Securities*, 133, *Accounting for Derivatives and Hedging Activities*, and 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. However, it also introduces concepts such as the principal and most advantageous markets and the fair value hierarchy of inputs (further discussed in this alert).<sup>10/</sup>

In planning and performing procedures in response to the risk associated with fair value measurements, the auditor should obtain an understanding of the company's process for determining fair value measurements and disclosures, including relevant controls.<sup>11/</sup> In addition, the auditor should, among other things -

- Evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.<sup>12/</sup> For example, the fact that transaction volume in a particular market is lower than in previous periods may not necessarily support an assumption that transactions in that market constituted forced or distressed sales.
- If management relies on historical financial information in the development of an assumption, consider the extent to which such reliance is justified. However, historical information might not be

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<sup>8/</sup> Ibid

<sup>9/</sup> See SOP 94-6, paragraph .13.

<sup>10/</sup> See SFAS 157, paragraphs 8, 22, and 23.

<sup>11/</sup> See AU sec. 328.09.

<sup>12/</sup> See AU sec. 328.26.

representative of future conditions or events.<sup>13/</sup> For example, an auditor should evaluate whether a company's use of historical default rates, in an environment in which default rates are increasing, is justified.

- Evaluate whether the company's method for determining fair value measurements is applied consistently and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the company.<sup>14/</sup> For example, the relative weightings in a company's model may not be reasonable in situations where there has been a change in market conditions. In such cases, auditors should consider whether compliance with applicable accounting standards might require a change in the model.

Inputs based on a company's own data may be more susceptible to preparer bias because they may not be based on observable market inputs.<sup>15/</sup> In such cases, the auditor should be aware of the increased risk of management bias and address the related risk of material misstatement.<sup>16/</sup>

### **Classification Within the Fair Value Hierarchy Under SFAS 157**

Under SFAS 157, a company must determine the appropriate level in the fair value hierarchy for each fair value measurement. The fair value hierarchy in SFAS 157 prioritizes the inputs, which refer broadly to assumptions market

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<sup>13/</sup> See AU sec. 328.37.

<sup>14/</sup> See AU sec. 328.19. Also, under SFAS 157, paragraph 20, a change in valuation technique or its application, is appropriate if the change results in a measurement that is equally or more representative of fair value in the circumstances.

<sup>15/</sup> See AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Paragraph .39 notes that certain accounts, classes of transactions, and assertions may have high inherent risk due to a high degree of management judgment and subjectivity. They also may represent fraud risks because they are susceptible to management manipulation.

<sup>16/</sup> AU sec 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .36, provides that the risk of material misstatement is generally greater when account balances include estimates because of the inherent subjectivity in estimating future events.

participants would use in pricing an asset or liability, into three levels. It gives the highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.<sup>17/</sup> The level in the fair value hierarchy within which a fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- Level 2 inputs are inputs other than quoted prices within Level 1 that are observable for the asset or liability, either directly or indirectly. A significant adjustment to a Level 2 input could result in the Level 2 measurement becoming a Level 3 measurement.
- Level 3 inputs are unobservable inputs for the asset or liability.<sup>18/</sup>

Because there are different consequences associated with each of the three levels of the hierarchy, the auditor should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. For example, an asset or liability with Level 1 inputs generally must be measured using unadjusted quoted prices in an active market, while an asset or liability with Level 2 inputs is measured using observable market inputs other than quoted prices included in Level 1. Accordingly, a Level 2 measurement might allow for more discretion or judgment on the part of management than a Level 1 measurement. As another example, the required disclosures associated with Level 3 measurements are more extensive than those associated with Level 1 and Level 2 measurements.

The auditor's opinion is based on, among other things, his or her judgment as to whether the financial statements and related notes are informative of

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<sup>17/</sup> See SFAS 157, paragraph 21. Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. Unobservable inputs are those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

<sup>18/</sup> See SFAS 157, paragraphs 22 - 32.



matters that may affect their use, understanding, and interpretation.<sup>19/</sup> In evaluating whether a company's disclosures are complete, accurate, and in conformity with SFAS 157, the auditor should be aware that a financial statement disclosure that is not in accordance with GAAP could be a misstatement of the financial statements.<sup>20/</sup>

### **Using the Work of Specialists**

Management and auditors frequently use the work of a specialist in preparing and auditing financial statements containing complex fair value measurements.

AU sec. 328 states that 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.<sup>21/</sup> As part of the consideration, the auditor should evaluate whether he or she has the necessary skill and knowledge to plan and perform audit procedures related to the fair value measurement. Factors to consider include –

- Significant use of unobservable inputs;
- Complexity of the valuation technique; and
- Materiality of the fair value measurement.

AU sec. 336, *Using the Work of a Specialist*, provides direction that applies when the auditor uses the work of a specialist, whether the specialist is engaged by the company or the auditor. It states that 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, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements.<sup>22/</sup> In obtaining an understanding of the specialist's methods, the auditor should consider whether the method will result in a measurement that is

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<sup>19/</sup> See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraph .04.

<sup>20/</sup> See AU sec. 9312, *Audit Risk and Materiality in Conducting an Audit: Auditing Interpretations of Section 312*, paragraphs .01 and .02.

<sup>21/</sup> See AU sec. 328.20.

<sup>22/</sup> See AU sec. 336.12



in conformity with the applicable accounting standards.<sup>23/</sup> In addition, the auditor should evaluate, in accordance with AU sec. 328, the assumptions developed by a specialist engaged or employed by management.<sup>24/</sup>

Additionally, the auditor should evaluate the specialist's qualifications, including the specialist's experience in the type of work under consideration, and obtain an understanding of the work performed by the specialist, including the appropriateness of using the specialist's work for the intended purpose.<sup>25/</sup> In the context of this practice alert, the intended purpose of the specialist's work is the valuation of assets and liabilities for use in financial statements prepared in conformity with GAAP.

### **Use of a Pricing Service**

If a company uses a pricing service for its fair value measurements, the auditor should determine the nature of the information provided by the pricing service. For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs (such as prices for similar assets), or fair value measurements based on a model, and adjust his or her audit procedures based on the nature of the information provided by the pricing service.<sup>26/</sup> In addition, if the price is not based on quoted prices from an active market or observable inputs (such as prices for similar assets), the auditor should obtain an understanding of the model and evaluate whether the assumptions are reasonable.<sup>27/</sup>

There are additional factors for the auditor to consider under SFAS 157. For example, under SFAS 157, a fair value measurement assumes that the transaction occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. The principal market is one in which the reporting entity would sell the asset or transfer the liability with the greatest volume and level of activity. If there is a principal market,

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<sup>23/</sup> See AU secs. 328.03. and 336.09

<sup>24/</sup> AU sec. 328 provides that management's assumptions used in fair value measurements or disclosures include assumptions developed by a specialist engaged or employed by management. See AU sec. 328.05, footnote 2.

<sup>25/</sup> See AU sec. 336.08 - .09.

<sup>26/</sup> The evaluation of pricing information also is applicable to fair value measurements that a company obtains from other third parties.

<sup>27/</sup> See AU secs. 328.05 and 336.12. In addition, see AU sec. 332.39.

under SFAS 157, the fair value measurement represents the price in that market even if the price in a different market is potentially more advantageous.<sup>28/</sup>

Under SFAS 157, when a company uses a pricing service, the auditor should evaluate whether the assumptions used by the pricing service reflect the price to sell the asset or paid to transfer the liability in the principal market (or most advantageous market if the company has no principal market) of the company. If the pricing service valuation is based on actual trades or quotes, the auditor should evaluate whether those traded or quoted prices would be available to the company in the company's principal market (or most advantageous market, if the company has no principal market). For example, a pricing service might provide an amount for which a large financial institution could sell the financial instrument. However, a company that owns that financial instrument might not be able to transact in the same market as a large financial institution. If the price available to a large financial institution would not be available to the company, then that price may not be an appropriate measure of fair value under SFAS 157.

### **Contact Information**

Inquiries concerning this Staff Practice Alert may be directed to –

Thomas Ray, Chief Auditor and Director of Professional Standards, 202-207-9112, [rayt@pcaobus.org](mailto:rayt@pcaobus.org)

Martin Baumann, Director, Office of Research and Analysis, 202-207-9192, [baumannm@pcaobus.org](mailto:baumannm@pcaobus.org)

Greg Fletcher, Associate Chief Auditor, 202-207-9203, [fletcher@pcaobus.org](mailto:fletcher@pcaobus.org)

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<sup>28/</sup>

See FASB Statement 157, paragraph 8.

## **APPENDIX B**

# **SEC and FASB Staff Clarifications on Fair Value Accounting**

**September 30, 2008**

## **SEC Office of the Chief Accountant and FASB Staff Clarifications on Fair Value Accounting**

### **FOR IMMEDIATE RELEASE 2008-234**

*Washington, D.C., Sept. 30, 2008* — The current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors, and users of financial information. The SEC's Office of the Chief Accountant and the staff of the FASB have been engaged in extensive consultations with participants in the capital markets, including investors, preparers, and auditors, on the application of fair value measurements in the current market environment.

There are a number of practice issues where there is a need for immediate additional guidance. The SEC's Office of the Chief Accountant recognizes and supports the productive efforts of the FASB and the IASB on these issues, including the IASB Expert Advisory Panel's Sept. 16, 2008 draft document, the work of the FASB's Valuation Resource Group, and the IASB's upcoming meeting on the credit crisis. To provide additional guidance on these and other issues surrounding fair value measurements, the FASB is preparing to propose additional interpretative guidance on fair value measurement under U.S. GAAP later this week.

While the FASB is preparing to provide additional interpretative guidance, SEC staff and FASB staff are seeking to assist preparers and auditors by providing immediate clarifications. The clarifications SEC staff and FASB staff are jointly providing today, based on the fair value measurement guidance in FASB Statement No. 157, Fair Value Measurements (Statement 157), are intended to help preparers, auditors, and investors address fair value measurement questions that have been cited as most urgent in the current environment.

\* \* \*

### **Can management's internal assumptions (e.g., expected cash flows) be used to measure fair value when relevant market evidence does not exist?**

Yes. When an active market for a security does not exist, the use of management estimates that incorporate current market participant expectations of future cash flows, and include appropriate risk premiums, is acceptable. Statement 157 discusses a range of information and valuation techniques that a reasonable preparer might use to estimate fair value when relevant market data may be unavailable, which may be the case during this period of market uncertainty. This can, in appropriate circumstances, include expected cash flows from an asset. Further, in some cases using unobservable inputs (level 3) might be more appropriate than using observable inputs (level 2); for example, when significant adjustments are required to available observable inputs it may be appropriate to utilize an estimate based primarily on unobservable inputs. The determination of fair value often

requires significant judgment. In some cases, multiple inputs from different sources may collectively provide the best evidence of fair value. In these cases expected cash flows would be considered alongside other relevant information. The weighting of the inputs in the fair value estimate will depend on the extent to which they provide information about the value of an asset or liability and are relevant in developing a reasonable estimate.

**How should the use of "market" quotes (e.g., broker quotes or information from a pricing service) be considered when assessing the mix of information available to measure fair value?**

Broker quotes may be an input when measuring fair value, but are not necessarily determinative if an active market does not exist for the security. In a liquid market, a broker quote should reflect market information from actual transactions. However, when markets are less active, brokers may rely more on models with inputs based on the information available only to the broker. In weighing a broker quote as an input to fair value, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (e.g. whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

**Are transactions that are determined to be disorderly representative of fair value? When is a distressed (disorderly) sale indicative of fair value?**

The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence. Determining whether a particular transaction is forced or disorderly requires judgment.

**Can transactions in an inactive market affect fair value measurements?**

Yes. A quoted market price in an active market for the identical asset is most representative of fair value and thus is required to be used (generally without adjustment). Transactions in inactive markets may be inputs when measuring fair value, but would likely not be determinative. If they are orderly, transactions should be considered in management's estimate of fair value. However, if prices in an inactive market do not reflect current prices for the same or similar assets, adjustments may be necessary to arrive at fair value.

A significant increase in the spread between the amount sellers are "asking" and the price that buyers are "bidding," or the presence of a relatively small number of

"bidding" parties, are indicators that should be considered in determining whether a market is inactive. The determination of whether a market is active or not requires judgment.

### **What factors should be considered in determining whether an investment is other-than-temporarily impaired?**

In general, the greater the decline in value, the greater the period of time until anticipated recovery, and the longer the period of time that a decline has existed, the greater the level of evidence necessary to reach a conclusion that an other-than-temporary decline has not occurred.

Determining whether impairment is other-than-temporary is a matter that often requires the exercise of reasonable judgment based upon the specific facts and circumstances of each investment. This includes an assessment of the nature of the underlying investment (for example, whether the security is debt, equity or a hybrid) which may have an impact on a holder's ability to assess the probability of recovery.

Existing U.S. GAAP does not provide "bright lines" or "safe harbors" in making a judgment about other-than-temporary impairments. However, "rules of thumb" that consider the nature of the underlying investment can be useful tools for management and auditors in identifying securities that warrant a higher level of evaluation.

To assist in making this judgment, SAB Topic 5M<sup>1</sup> provides a number of factors that should be considered. These factors are not all inclusive of the potential factors that may be considered individually, or in combination with other factors, when considering whether an other-than-temporary impairment exists. Factors to consider include the following:

- The length of the time and the extent to which the market value has been less than cost;
- The financial condition and near-term prospects of the issuer, including any specific events, which may influence the operations of the issuer such as changes in technology that impair the earnings potential of the investment or the discontinuation of a segment of the business that may affect the future earnings potential; or
- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

All available information should be considered in estimating the anticipated recovery period.

\* \* \*

Finally, because fair value measurements and the assessment of impairment may require significant judgments, clear and transparent disclosures are critical to providing investors with an understanding of the judgments made by management.

In addition to the disclosures required under existing U.S. GAAP, including Statement 157, the SEC's Division of Corporation Finance recently issued letters in [March](#) and [September](#) that are available on the SEC's Web site to provide real-time guidance for issuers to consider in enhancing the transparency of fair value measurements to investors. Additionally, the SEC staff and the FASB staff will continue to consult with capital market participants on issues encountered in the application of fair value measurements.

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<sup>1</sup> AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, of the PCAOB Interim Auditing Standards also provide factors to consider when evaluating whether an impairment is other-than-temporary.



## **APPENDIX C**

**FASB Staff Position**  
**FAS 157-3: *Determining the Fair Value of***  
***a Financial Asset When the Market for***  
***That Asset Is Not Active***

**October 10, 2008**

## **FASB STAFF POSITION**

### **No. FAS 157-3**

**Title:** Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active

**Date Issued:** October 10, 2008

### **Objective**

1. This FASB Staff Position (FSP) clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

### **Background**

2. Statement 157 was issued in September 2006, and is effective for financial assets and financial liabilities for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Early application was encouraged. FSP FAS 157-2, *Effective Date of FASB Statement No. 157*, amended Statement 157 to delay the effective date of Statement 157 for nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years.

3. Statement 157 establishes a single definition of fair value and a framework for measuring fair value in generally accepted accounting principles (GAAP) that result in increased consistency and comparability in fair value measurements. Statement 157 also expands disclosures about fair value measurements, thereby improving the quality of information provided to users of financial statements. Statement 157 does not require any new fair value measurements.

4. The FASB staff obtained extensive input from various constituents, including financial statement users, preparers, and auditors, on determining fair value in accordance with Statement 157. Many of those constituents indicated that the fair value measurement framework in Statement 157 and related disclosures have improved the quality and transparency of financial information.

5. However, certain constituents expressed concerns that Statement 157 does not provide sufficient guidance on how to determine the fair value of financial assets when the market for that asset is not active. Application issues include:

- a. How the reporting entity's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist
  - b. How available observable inputs in a market that is not active should be considered when measuring fair value
  - c. How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.
6. The Office of the Chief Accountant of the SEC and the FASB staff jointly issued a press release on September 30, 2008, that addresses similar Statement 157 application issues. That press release provides financial statement users, preparers, and auditors with additional guidance useful in dealing with those issues. The guidance included in this FSP is consistent with and amplifies the guidance contained in that press release.

<p>All paragraphs in this FSP have equal authority. Paragraphs in bold set out the main principles.</p>
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## **FASB Staff Position**

### **Scope**

7. **This FSP applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157.**
8. **This FSP clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.**
9. Key existing principles of Statement 157 illustrated in the example include:
- a. A fair value measurement represents the price at which a transaction would occur between market participants at the measurement date. As discussed in Statement 157, in situations in which there is little, if any, market activity for an asset at the measurement date, the fair value measurement objective remains the same, that is, the price that would be received by the holder of the financial asset in an orderly transaction (an exit price notion) that is not a forced liquidation or distressed sale at the measurement date.<sup>1</sup> Even in times of market dislocation, it is not appropriate to conclude that all market activity represents forced

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<sup>1</sup> See paragraph 7 of Statement 157.

liquidations or distressed sales. However, it is also not appropriate to automatically conclude that any transaction price is determinative of fair value. Determining fair value in a dislocated market depends on the facts and circumstances and may require the use of significant judgment about whether individual transactions are forced liquidations or distressed sales.

- b. In determining fair value for a financial asset, the use of a reporting entity's own assumptions about future cash flows and appropriately risk-adjusted discount rates is acceptable when relevant observable inputs are not available. Statement 157 discusses a range of information and valuation techniques that a reporting entity might use to estimate fair value when relevant observable inputs are not available.<sup>2</sup> In some cases an entity may determine that observable inputs (Level 2) require significant adjustment based on unobservable data and thus would be considered a Level 3 fair value measurement. For example, in cases where the volume and level of trading activity in the asset have declined significantly, the available prices vary significantly over time or among market participants, or the prices are not current, the observable inputs might not be relevant and could require significant adjustment. Regardless of the valuation technique used, an entity must include appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.
- c. Broker (or pricing service) quotes may be an appropriate input when measuring fair value, but they are not necessarily determinative if an active market does not exist for the financial asset. In an active market, a broker quote should reflect market information from actual transactions. However, when markets are not active, brokers may rely more on models with inputs based on information available only to the broker. In weighing a broker quote as an input to a fair value measurement, an entity should place less reliance on quotes that do not reflect the result of market transactions. Further, the nature of the quote (for example, whether the quote is an indicative price or a binding offer) should be considered when weighing the available evidence.

10. For recurring fair value measurements using significant unobservable inputs (Level 3), paragraph 32 of Statement 157 requires an entity to reconcile the beginning and ending balances, including separately presenting changes that occurred during the period that are attributable to transfers in and/or out of Level 3. For both recurring and nonrecurring fair value measurements using significant unobservable inputs (Level 3), paragraphs 32 and 33 of Statement 157 require an entity to describe the inputs and the information used to develop those inputs.<sup>3</sup>

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<sup>2</sup> Paragraph B6 of Statement 157 describes two present value techniques for determining fair value. The present value techniques differ in how they adjust for risk and in the type of cash flows they use.

<sup>3</sup> The Board observes that the SEC's Division of Corporation Finance issued letters in March 2008 and September 2008 for issuers to consider in enhancing the transparency of disclosures relating to fair value

## Amendment to Add an Illustrative Example to Statement 157

11. Statement 157 is amended as follows: [Added text is underlined.]

- a. Paragraphs A32A–A32F and the heading preceding them are added as follows:

*Example 11—Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*

**Note:** The conclusions reached in this example are based on the assumed facts and circumstances presented. Other approaches to determining fair value may be appropriate. Also, this example assumes that the observable transactions considered in determining fair value were not forced liquidations or distressed transactions.

A32A. On January 1, 20X8, Entity A invested in a AA-rated tranche of a collateralized debt obligation security. The underlying collateral for the collateralized debt obligation security is unguaranteed nonconforming residential mortgage loans. Prior to June 30, 20X8, Entity A was able to determine the fair value of the collateralized debt obligation security using a market approach valuation technique based on Level 2 inputs that did not require significant adjustment. The Level 2 inputs included:

- a. Quoted prices in active markets for similar collateralized debt obligation securities with insignificant adjustments for differences between the collateralized debt obligation security that Entity A holds and the similar collateralized debt obligation securities
- b. Quoted prices in markets that are not active that represent current transactions for the same or similar collateralized debt obligation securities that do not require significant adjustment based on unobservable inputs.

A32B. Since June 30, 20X8, the market for collateralized debt obligation securities has become increasingly inactive. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which collateralized debt obligation securities trade and then by a significant decrease in the volume of trades relative to historical levels as well as other relevant factors. At September 30, 20X8 (the measurement date), Entity A determines that the market for its collateralized debt obligation security is not active and that markets for similar collateralized debt obligation securities (such as higherrated tranches

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measurements.

within the same collateralized debt obligation security vehicle) also are not active. That determination was made considering that there are few observable transactions for the collateralized debt obligation security or similar collateralized debt obligation securities, the prices for those transactions that have occurred are not current, and the observable prices for those transactions vary substantially either over time or among market makers, thus reducing the potential relevance of those observations. Consequently, while Entity A appropriately considers those observable inputs, ultimately, Entity A's collateralized debt obligation security will be classified within Level 3 of the fair value hierarchy because Entity A determines that significant adjustments using unobservable inputs are required to determine fair value at the measurement date.

A32C. Entity A determines that an income approach valuation technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, which would now require significant adjustments.<sup>21a</sup> Specifically, Entity A uses the discount rate adjustment technique described in Appendix B of Statement 157 to determine fair value.

A32D. Entity A determines that the appropriate discount rate<sup>21b</sup> used to discount the contractual cash flows<sup>21c</sup> of its collateralized debt obligation security is 22 percent after considering the following:

- a. The implied rate of return at the last date on which the market was considered active for the collateralized debt obligation security was 15 percent. Based on an analysis of available observable inputs for mortgage-related debt securities, Entity A determines that market rates of return generally have increased in the marketplace since the last date on which the market was considered active for the collateralized debt obligation security. Entity A estimates that credit spreads have widened by approximately 100 basis points and liquidity risk premiums have increased during that period by approximately 400 basis points. Other risks (for example, interest rate risk) have not changed. Using this information, Entity A estimates that an indication of an appropriate rate of return for the

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<sup>21a</sup> See paragraphs 20 and 21 of Statement 157.

<sup>21b</sup> See paragraphs B7–B11 of Statement 157.

<sup>21c</sup> The discount rate adjustment technique described in paragraphs B7–B11 of Statement 157 would not be appropriate when determining whether the change in fair value results in an impairment and/or necessitates a change in yield under EITF Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets," because that technique uses contractual cash flows rather than cash flows expected by market participants.

collateralized debt obligation security is 20 percent.<sup>21d</sup> In making that determination, Entity A considered all available market information that could be obtained without undue cost and effort. For this collateralized debt obligation security, the available market information used in assessing the risks in the security (including nonperformance risk [for example, default risk and collateral value risk] and liquidity risk) included:

- (1) Quoted prices that are not current for the same or similar collateralized debt obligation securities
  - (2) Relevant reports issued by analysts and ratings agencies
  - (3) The current level of interest rates and any directional movements in relevant indexes, such as credit risk indexes
  - (4) Information about the performance of the underlying mortgage loans, such as delinquency and foreclosure rates, loss experience, and prepayment rates
  - (5) Other relevant observable inputs.
- b. Two indicative quotes (that is, nonbinding quotes) for the collateralized debt obligation security from brokers imply a rate of return of 23 percent and 27 percent. The indicative quotes are based on proprietary pricing models utilizing significant unobservable inputs (that is, Level 3 inputs), rather than actual transactions.

A32E. Because Entity A has multiple indications of the appropriate rate of return that market participants would consider relevant in estimating fair value, it evaluates and weighs, as appropriate, the respective indications of the appropriate rate of return, considering the reasonableness of the range indicated by the results. Entity A concludes that 22 percent is the point within the range of relevant inputs that is most representative of fair value in the circumstances. Entity A placed more weight on the 20 percent estimated rate of return (that is, its own estimate) because (a) the indications of an appropriate rate of return provided by the broker quotes were nonbinding quotes based on the brokers' own models using significant unobservable inputs, and (b) Entity A was able to corroborate some of the inputs, such as default rates, with relevant observable market data, which it

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<sup>21d</sup> Calculated as the 15 percent implied rate of return at the last date on which the market was considered active, plus the increase in (a) credit spreads of 100 basis points (1 percent) and (b) liquidity risk premiums of 400 basis points (4 percent).



used to make significant adjustments to the implied rate of return when the market was last considered active.

A32F. In accordance with the requirements of Statement 157, Entity A determines that the risk-adjusted discount rate appropriately reflects the reporting entity's estimate of the assumptions that market participants would use to estimate the selling price of the asset at the measurement date. Risks incorporated in the discount rate include nonperformance risk (for example, default risk and collateral value risk) and liquidity risk (that is, the compensation that a market participant receives for buying an asset that is difficult to sell under current market conditions).

## **Effective Date and Transition**

12. This FSP shall be effective upon issuance, including prior periods for which financial statements have not been issued. Revisions resulting from a change in the valuation technique or its application shall be accounted for as a change in accounting estimate (FASB Statement No. 154, *Accounting Changes and Error Corrections*, paragraph 19). The disclosure provisions of Statement 154 for a change in accounting estimate are not required for revisions resulting from a change in valuation technique or its application.

The provisions of this FSP need not be applied to immaterial items.
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