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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

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.[1/]

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,

[1/] 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*.[2/] 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.[3/]

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

[2/] 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.

[3/] 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.[4/] 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;[5/]

- 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;[6/]

- The estimate of fair value should consider prices for similar assets;[7/] and

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

[5/] 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.

[6/] 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.

[7/] 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. [8/]

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.[9/]

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).[10/]

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.[11/] In addition, the auditor should, among other things -

- Evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.[12/] 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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8/ Ibid.

9/ See SOP 94-6, paragraph .13.

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

11/ See AU sec. 328.09.

12/ See AU sec. 328.26.

representative of future conditions or events.[13] 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.[14] 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.[15] In such cases, the auditor should be aware of the increased risk of management bias and address the related risk of material misstatement.[16]

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 participants would use in pricing an asset or liability, into three levels. It gives the

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[13] See AU sec. 328.37.

[14] 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.

[15] 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.

[16] 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.

highest priority to quoted prices (unadjusted) in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.[17/] 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.[18/]

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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17/ 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.

18/ See SFAS 157, paragraphs 22 - 32.

matters that may affect their use, understanding, and interpretation.[19] 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.[20]

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.[21] 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.[22] 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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[19] See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, paragraph .04.

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

[21] See AU sec. 328.20.

[22] See AU sec. 336.12.

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

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.[25/] 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.[26/] 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.[27/]

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

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[23/] See AU secs. 328.03. and 336.09.

[24/] 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.

[25/] See AU sec. 336.08 - .09.

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

[27/] See AU secs. 328.05 and 336.12. In addition, see AU sec. 332.39.

liability with the greatest volume and level of activity. If there is a principal market, 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.[28/]

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.

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[28/] See FASB Statement 157, paragraph 8.