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STAFF AUDIT PRACTICE ALERT NO. 4

AUDITOR CONSIDERATIONS REGARDING FAIR VALUE MEASUREMENTS, DISCLOSURES, AND OTHER-THAN-TEMPORARY IMPAIRMENTS

APRIL 21, 2009

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 Staff 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.

On April 9, 2009, the Financial Accounting Standards Board ("FASB") issued three FASB Staff Positions ("FSP" or, collectively, "the FSPs"):

- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ("FSP FAS 157-4")

- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ("FSP FAS 115-2")

- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ("FSP FAS 107-1")[1/]

The objectives of these FSPs are to: (1) provide "additional guidance for estimating fair value in accordance with FASB Statement No. 157, *Fair Value Measurements*, when the volume and level of activity for the asset or liability have significantly decreased" including "guidance on identifying circumstances that indicate a transaction is not orderly,"[2/] (2) amend "the other-than-temporary impairment guidance

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1/ The respective FSPs are available at:
— http://www.fasb.org/pdf/fsp_fas157-4.pdf
— http://www.fasb.org/pdf/fsp_fas115-2andfas124-2.pdf
— http://www.fasb.org/pdf/fsp_fas107-1andapb28-1.pdf

2/ FSP FAS 157-4, paragraph 1.

in U.S. GAAP for debt securities to make the guidance more operational and to improve the presentation and disclosure of other-than-temporary impairments on debt and equity securities in the financial statements,"[3/] and (3) "require disclosures about fair value of financial instruments for interim reporting periods for publicly traded companies as well as in annual financial statements."[4/]

The purpose of this staff audit practice alert is to inform auditors about potential implications of the FSPs on reviews of interim financial information and annual audits. This alert addresses the following topics: (1) reviews of interim financial information ("reviews"); (2) audits of financial statements, including integrated audits; (3) disclosures; and (4) auditor reporting considerations. While this alert highlights certain areas, it is not intended to serve as a substitute for the relevant auditing standards.

In considering the effects of the FSPs on their audits and reviews, auditors should be aware that some PCAOB standards include descriptions of accounting requirements that are no longer current. The accounting standards set by the FASB are recognized by the U.S. Securities and Exchange Commission ("SEC") as generally accepted.[5/] Auditors should look to those standards and to the requirements of the SEC,[6/] rather than the standards of the PCAOB, for current accounting requirements and disregard descriptions of accounting requirements in PCAOB standards that are inconsistent with the FSPs. The PCAOB has a project on its standards-setting agenda to address the auditing standards related to auditing accounting estimates and auditing

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3/ FSP FAS 115-2, paragraph 2. This FSP does not amend existing recognition and measurement guidance related to other-than-temporary impairment of equity securities. On April 14, 2009, the SEC's staff released Staff Accounting Bulletin ("SAB") No. 111, *Other Than Temporary Impairment of Certain Investments in Equity Securities,* which amends SAB Topic 5.M. SAB Topic 5.M. now excludes debt securities from its scope while maintaining the SEC staff's views related to equity securities.

4/ FSP FAS 107-1, paragraph 1.

5/ SEC, *Policy Statement: Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter*, Exchange Act Release No. 34-47743 (April 25, 2003). The PCAOB has no authority to prescribe the form or content of an issuer's financial statements. Accordingly, while this staff audit practice alert describes applicable generally accepted accounting principles ("GAAP"), it does not establish or interpret GAAP.

6/ Auditors should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company. See AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

fair value measurements. In connection with this project, the PCAOB is planning to remove descriptions of accounting requirements from these standards. In general, as the PCAOB replaces or substantively revises its interim standards, it will continue to remove descriptions of accounting requirements from those auditing standards.

Reviews of Interim Financial Information

The objective of a review is to provide the auditor with a basis for communicating whether he or she is aware of any material modifications that should be made to the interim financial information for it to conform with generally accepted accounting principles ("GAAP"). A review differs significantly from an audit and consists principally of performing analytical procedures and making inquiries of persons responsible for financial and accounting matters.[7/] A review does not provide a basis for expressing an opinion about whether the financial statements are presented fairly, in all material respects, in conformity with GAAP.[8/] For an audit, PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.[9/]

As part of the review, the auditor should, among other things, make inquiries of members of management who have responsibility for financial and accounting matters. If relevant to the company, the auditor should include in these inquiries questions about the implementation of the FSPs.[10/]

The auditor also should determine whether any matters described in AU sec. 380, *Communication With Audit Committees* ("AU sec. 380"), as they relate to the interim financial information, have been identified.[11/] If such matters have been identified, the auditor should communicate those matters to the audit committee or be satisfied, through discussion with the audit committee, that management has communicated such matters to the audit committee.[12/] Matters to be communicated

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7/ Paragraph .07 of AU sec. 722, *Interim Financial Information* ("AU sec. 722").

8/ Ibid.

9/ Paragraph .08 of AU sec. 508, *Reports on Audited Financial Statements*. An audit includes, among other things, examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.

10/ AU sec. 722.18(c).

11/ AU sec. 722.34.

12/ Ibid.

include: a change in a significant accounting policy affecting the interim financial information; accounting estimates and management's judgments about those accounting estimates; processes management uses to formulate sensitive accounting estimates; and the auditor's judgment about the quality, not just the acceptability, of the company's accounting policies.[13/] Depending upon the circumstances, the implementation of the FSPs may present matters that should be communicated to the audit committee.

Audits of Financial Statements, Including Integrated Audits

FSP FAS 157-4 provides additional guidance for estimating fair value when the volume and level of activity for an asset or liability have significantly decreased.[14/] In performing procedures under AU sec. 328, *Auditing Fair Value Measurements and Disclosures* ("AU sec. 328"), the auditor is required to, among other things, obtain an understanding of the company's process for determining fair value measurements and disclosures and of the relevant controls sufficient to assess the risk of material misstatement, and to plan the nature, timing, and extent of the audit procedures.[15/] Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures.[16/] Because of the wide range of possible fair value measurements, from relatively simple to complex, and the varying levels of risk of material misstatement associated with the process for determining fair values, the auditor's planned audit procedures can vary significantly in nature, timing, and extent.[17/] The auditor's substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) reviewing subsequent events and transactions.[18/]

FSP FAS 115-2 amends the guidance for recognizing an other-than-temporary impairment ("OTTI") for a debt security.[19/] The auditor is required to evaluate a

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[13/] AU secs. 380.07-.08, AU sec. 380.11, and AU sec. 722.34.

[14/] FSP FAS 157-4, paragraphs 12-16.

[15/] AU secs. 328.09 and 328.13.

[16/] AU sec. 328.23.

[17/] Ibid.

[18/] Ibid.

[19/] FSP FAS 115-2, paragraph 7.

company's conclusions about the need to recognize an impairment loss.[20/] When a company has recognized an impairment loss, the auditor should gather evidence supporting the amount of the impairment adjustment recorded and determine whether the company has appropriately followed GAAP.[21/] In certain circumstances, a company is required to separate the amount of the OTTI representing credit losses (as defined by FSP FAS 115-2) and the amount representing all other factors.[22/] In those situations, the auditor's objective is to obtain sufficient competent evidential matter to provide reasonable assurance that these estimates are reasonable in the circumstances and that they are presented and disclosed in conformity with GAAP.[23/] In evaluating reasonableness, the auditor should obtain an understanding of how the company developed the estimates.[24/] In addition, the auditor should discuss an accounting change due to FSP FAS 115-2 and other related topics (as described in the previous section related to interim financial information), with the audit committee in connection with the audit of the financial statements, including integrated audits.[25/]

Disclosures

The FSPs require additional disclosures regarding fair value measurements and OTTI. For example (1) FSP FAS 157-4 requires a company to disclose changes in valuation techniques and related inputs for fair value measurements in interim and annual periods and to provide additional disclosures under Statement No. 157, *Fair Value Measurements*[26/] and (2) FSP FAS 115-2 requires a company to disclose information that enables users to understand the reasons that a portion of OTTI was not recognized in earnings and the methodology and significant inputs used to calculate the

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20/ Paragraph .48 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

21/ Ibid.

22/ FSP FAS 115-2, paragraphs 29-30.

23/ Paragraph .07 of AU sec. 342, *Auditing Accounting Estimates*.

24/ AU sec. 342.10.

25/ AU secs. 380.07 and 380.11. Also, Section 10A(k) of the Securities and Exchange Act of 1934 requires the auditor to communicate certain matters to the audit committee.

26/ FSP FAS 157-4, paragraph 20.

portion of OTTI that was recognized in earnings.[27/] The auditor should evaluate whether the financial statement disclosures are in conformity with the FSPs.[28/]

In addition, the auditor should read the other information accompanying the interim and annual financial statements contained in reports filed with the SEC.[29/] For example, the Management's Discussion and Analysis of Financial Condition and Results of Operations section of annual reports and other filings might include discussions regarding fair value measurements and OTTI.[30/] The auditor should consider whether that information or the manner of its presentation is materially inconsistent with the financial statements. If the auditor concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the auditor should determine if the financial statements, the audit report, or both require revision. If the auditor concludes that the financial statements or audit report do not require revision, the auditor should request the company to revise the other information.[31/]

Auditor Reporting Considerations

FSP FAS 157-4 states that revisions resulting from a change in the valuation technique or its application are to be accounted for as a change in accounting estimate. In the period of adoption, entities are required to disclose a change, if any, in valuation technique and related inputs and quantify the total effect, if practicable, by major category.[32/] In addition, FSP FAS 115-2 requires the company to recognize the cumulative effect of initially applying the FSP as an adjustment to the opening balance

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[27/] FSP FAS 115-2, paragraph 38.

[28/] The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which the auditor is aware at the time. See paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

[29/] AU sec. 722.18(f) and paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements* ("AU sec. 550").

[30/] For example, see the discussion of critical accounting policies and critical accounting estimates, respectively, in SEC Release Nos. 33-8040, *Cautionary Advice Regarding Disclosure About Critical Accounting Policies* (December 12, 2001) and 33-8350, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations* (December 29, 2003).

[31/] AU secs. 550.04-05.

[32/] FSP FAS 157-4, paragraph 22.

of retained earnings, as of the beginning of the period in which FSP FAS 115-2 is adopted, with a corresponding adjustment to accumulated other comprehensive income.[33/]

The auditor should evaluate whether the company's accounting for and disclosure of the changes are in accordance with the FSPs. To identify consistency matters that might affect the auditor's report, the auditor should evaluate whether the comparability of the financial statements between periods has been materially affected by changes in accounting principles. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[34/]

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33/ FSP FAS 115-2, paragraph 45.

34/ Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*