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# Review of Fair Value Calculations During Financial Statement Audits

Navigating SAS 57, SAS 73, SAS 101 and Other Standards in Testing Measurements and Disclosures

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WEDNESDAY, MAY 16, 2012

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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Today's faculty features:

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## AU Section 342

### *Auditing Accounting Estimates*

Source: SAS No. 57; SAS No. 113.

See section 9342 for interpretations of this section.

**Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.**

**.01** This section provides guidance to auditors on obtaining and evaluating sufficient appropriate audit evidence to support significant accounting estimates in an audit of financial statements in accordance with generally accepted auditing standards. For purposes of this section, an *accounting estimate* is an approximation of a financial statement element, item, or account. Accounting estimates are often included in historical financial statements because—

- a. The measurement of some amounts or the valuation of some accounts is uncertain, pending the outcome of future events.
- b. Relevant data concerning events that have already occurred cannot be accumulated on a timely, cost-effective basis.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.02** Accounting estimates in historical financial statements measure the effects of past business transactions or events, or the present status of an asset or liability. Examples of accounting estimates include net realizable values of inventory and accounts receivable, property and casualty insurance loss reserves, revenues from contracts accounted for by the percentage-of-completion method, and pension and warranty expenses.<sup>1</sup>

**.03** Management is responsible for making the accounting estimates included in the financial statements. Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

**.04** The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole. As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them. Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors. Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.

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<sup>1</sup> Additional examples of accounting estimates included in historical financial statements are presented in paragraph .16.

## Developing Accounting Estimates

**.05** Management is responsible for establishing a process for preparing accounting estimates. Although the process may not be documented or formally applied, it normally consists of—

- a.* Identifying situations for which accounting estimates are required.
- b.* Identifying the relevant factors that may affect the accounting estimate.
- c.* Accumulating relevant, sufficient, and reliable data on which to base the estimate.
- d.* Developing assumptions that represent management's judgment of the most likely circumstances and events with respect to the relevant factors.
- e.* Determining the estimated amount based on the assumptions and other relevant factors.
- f.* Determining that the accounting estimate is presented in conformity with applicable accounting principles and that disclosure is adequate.

The risk of material misstatement of accounting estimates normally varies with the complexity and subjectivity associated with the process, the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with the assumptions.

## Internal Control Related to Accounting Estimates

**.06** An entity's internal control may reduce the likelihood of material misstatements of accounting estimates. Specific relevant aspects of internal control include the following:

- a.* Management communication of the need for proper accounting estimates
- b.* Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate
- c.* Preparation of the accounting estimate by qualified personnel
- d.* Adequate review and approval of the accounting estimates by appropriate levels of authority, including—
  1. Review of sources of relevant factors
  2. Review of development of assumptions
  3. Review of reasonableness of assumptions and resulting estimates
  4. Consideration of the need to use the work of specialists
  5. Consideration of changes in previously established methods to arrive at accounting estimates
- e.* Comparison of prior accounting estimates with subsequent results to assess the reliability of the process used to develop estimates
- f.* Consideration by management of whether the resulting accounting estimate is consistent with the operational plans of the entity.

## Evaluating Accounting Estimates

**.07** The auditor's objective when evaluating accounting estimates is to obtain sufficient appropriate audit evidence to provide reasonable assurance that—

- a. All accounting estimates that could be material to the financial statements have been developed.
- b. Those accounting estimates are reasonable in the circumstances.
- c. The accounting estimates are presented in conformity with applicable accounting principles<sup>[2]</sup> and are properly disclosed.<sup>3</sup>

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

## Identifying Circumstances That Require Accounting Estimates

**.08** In evaluating whether management has identified all accounting estimates that could be material to the financial statements, the auditor considers the circumstances of the industry or industries in which the entity operates, its methods of conducting business, new accounting pronouncements, and other external factors. The auditor should consider performing the following procedures:

- a. Consider assertions embodied in the financial statements to determine the need for estimates. (See paragraph .16 for examples of accounting estimates included in financial statements.)
- b. Evaluate information obtained in performing other procedures, such as—
  1. Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates that may indicate the need to make an accounting estimate (section 311, *Planning and Supervision*).
  2. Changes in the methods of accumulating information.
  3. Information concerning identified litigation, claims, and assessments (section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*), and other contingencies.
  4. Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.
  5. Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.
- c. Inquire of management about the existence of circumstances that may indicate the need to make an accounting estimate.

## Evaluating Reasonableness

**.09** In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are—

- a. Significant to the accounting estimate.
- b. Sensitive to variations.
- c. Deviations from historical patterns.
- d. Subjective and susceptible to misstatement and bias.

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<sup>[2]</sup> [Footnote deleted, October 2009, to reflect conforming changes necessary due to the withdrawal of SAS No. 69.]

<sup>3</sup> Section 431, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosures of material matters in light of the circumstances and facts of which he is aware.

The auditor normally should consider the historical experience of the entity in making past estimates as well as the auditor's experience in the industry. However, changes in facts, circumstances, or entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.<sup>4</sup>

**.10** In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

[As amended, effective for audits of financial statements for periods ending on or after December 15, 2006, by Statement on Auditing Standards No. 113.]

**.11** Review and test management's process. In many situations, the auditor assesses the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. The following are procedures the auditor may consider performing when using this approach:

- a. Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.
- b. Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose based on information gathered in other audit tests.
- c. Consider whether there are additional key factors or alternative assumptions about the factors.
- d. Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.
- e. Analyze historical data used in developing the assumptions to assess whether the data is comparable and consistent with data of the period under audit, and consider whether such data is sufficiently reliable for the purpose.
- f. Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.
- g. Review available documentation of the assumptions used in developing the accounting estimates and inquire about any other plans, goals, and objectives of the entity, as well as consider their relationship to the assumptions.
- h. Consider using the work of a specialist regarding certain assumptions (section 336, *Using the Work of a Specialist*).
- i. Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.

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<sup>4</sup> In addition to other evidential matter about the estimate, in certain instances, the auditor may wish to obtain written representation from management regarding the key factors and assumptions.

**.12** *Develop an expectation.* Based on the auditor's understanding of the facts and circumstances, he may independently develop an expectation as to the estimate by using other key factors or alternative assumptions about those factors.

**.13** *Review subsequent events or transactions.* Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2006, by Statement on Auditing Standards No. 113.]

**.14** As discussed in section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .56, the auditor evaluates the reasonableness of accounting estimates in relationship to the financial statements taken as a whole:

Because no one accounting estimate can be considered accurate with certainty, the auditor may determine that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may not be significant, and such difference would not be considered to be a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

## Effective Date

**.15** This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

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## Appendix

### Examples of Accounting Estimates

The following are examples of accounting estimates that are included in financial statements. The list is presented for information only. It should not be considered all-inclusive.

#### Receivables:

- Uncollectible receivables
- Allowance for loan losses
- Uncollectible pledges

#### Inventories:

- Obsolete inventory
- Net realizable value of inventories where future selling prices and future costs are involved
- Losses on purchase commitments

#### Financial instruments:

- Valuation of securities
- Trading versus investment security classification
- Probability of high correlation of a hedge
- Sales of securities with puts and calls

#### Productive facilities, natural resources and intangibles:

- Useful lives and residual values
- Depreciation and amortization methods
- Recoverability of costs
- Recoverable reserves

#### Accruals:

- Property and casualty insurance company loss reserves
- Compensation in stock option plans and deferred plans
- Warranty claims
- Taxes on real and personal property Renegotiation refunds
- Actuarial assumptions in pension costs

#### Revenues:

- Airline passenger revenue
- Subscription income
- Freight and cargo revenue
- Dues income
- Losses on sales contracts

#### Contracts:

- Revenue to be earned
- Costs to be incurred
- Percent of completion

#### Leases:

- Initial direct costs
- Executory costs
- Residual values

#### Litigation:

- Probability of loss
- Amount of loss

#### Rates:

- Annual effective tax rate in interim reporting
- Imputed interest rates on receivables and payables
- Gross profit rates under program method of accounting

#### Other:

- Losses and net realizable value on disposal of segment or restructuring of a business
- Fair values in nonmonetary exchanges
- Interim period costs in interim reporting
- Current values in personal financial statements

## AU Section 336

### *Using the Work of a Specialist*

(Supersedes SAS No. 11.)

Source: SAS No. 73.

See section 9336 for interpretations of this section.

Effective for audits of periods ending on or after December 15, 1994.

#### Introduction and Applicability

**.01** The purpose of this section is to provide guidance to the auditor who uses the work of a specialist in performing an audit in accordance with generally accepted auditing standards. For purposes of this section, a specialist is a person (or firm) possessing special skill or knowledge in a particular field other than accounting or auditing.<sup>1</sup>

**.02** Specialists to which this section applies include, but are not limited to, actuaries, appraisers, engineers, environmental consultants, and geologists. This section also applies to attorneys engaged as specialists in situations other than to provide services to a client concerning litigation, claims, or assessments to which section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, applies. For example, attorneys may be engaged by a client or by the auditor as specialists in a variety of other circumstances, including interpreting the provisions of a contractual agreement.

**.03** The guidance in this section is applicable when—

- a. Management engages or employs a specialist and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.
- b. Management engages a specialist employed by the auditor's firm to provide advisory services<sup>2</sup> and the auditor uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.
- c. The auditor engages a specialist and uses that specialist's work as audit evidence in performing substantive tests to evaluate material financial statement assertions.

[Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.04** The guidance provided in this section applies to audits of financial statements prepared in conformity with generally accepted accounting principles (GAAP)<sup>3</sup> and to engagements performed under section 623, *Special Reports*, including a comprehensive basis of accounting other than GAAP.

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<sup>1</sup> In general, the auditor's education, training, and experience enable him or her to be knowledgeable concerning income tax matters and to be competent to assess their presentation in the financial statements.

<sup>2</sup> The auditor should consider the effect, if any, that using the work of a specialist employed by the auditor's firm has on independence.

<sup>3</sup> References in this section to "financial statements" and to "generally accepted accounting principles" include special reports covered under section 623, *Special Reports*.

**.05** This section does not apply to situations covered by section 311, *Planning and Supervision*, in which a specialist employed by the auditor's firm participates in the audit.

## Decision to Use the Work of a Specialist

**.06** The auditor's education and experience enable him or her to be knowledgeable about business matters in general, but the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. During the audit, however, an auditor may encounter complex or subjective matters potentially material to the financial statements. Such matters may require special skill or knowledge and in the auditor's judgment require using the work of a specialist to obtain appropriate audit evidence. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.07** Examples of the types of matters that the auditor may decide require him or her to consider using the work of a specialist include, but are not limited to, the following:

- a. Valuation (for example, special-purpose inventories, high-technology materials or equipment, pharmaceutical products, complex financial instruments, real estate, restricted securities, works of art, and environmental contingencies)
- b. Determination of physical characteristics relating to quantity on hand or condition (for example, quantity or condition of minerals, mineral reserves, or materials stored in stockpiles)
- c. Determination of amounts derived by using specialized techniques or methods (for example, actuarial determinations for employee benefits obligations and disclosures, and determinations for insurance loss reserves<sup>4</sup>)
- d. Interpretation of technical requirements, regulations, or agreements (for example, the potential significance of contracts or other legal documents or legal title to property)

## Qualifications and Work of a Specialist

**.08** The auditor should consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:

- a. The professional certification, license, or other recognition of the competence of the specialist in his or her field, as appropriate
- b. The reputation and standing of the specialist in the views of peers and others familiar with the specialist's capability or performance
- c. The specialist's experience in the type of work under consideration

**.09** The auditor should obtain an understanding of the nature of the work performed or to be performed by the specialist. This understanding should cover the following:

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<sup>4</sup> In the specific situation involving the audit of an insurance entity's loss reserves, an outside loss reserve specialist—that is, one who is not an employee or officer of the insurance entity—should be used. When the auditor has the requisite knowledge and experience, the auditor may serve as the loss reserve specialist. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of recent authoritative literature.]

- a. The objectives and scope of the specialist's work
- b. The specialist's relationship to the client (see paragraphs .10 and .11)
- c. The methods or assumptions used
- d. A comparison of the methods or assumptions used with those used in the preceding period
- e. The appropriateness of using the specialist's work for the intended purpose<sup>5</sup>
- f. The form and content of the specialist's findings that will enable the auditor to make the evaluation described in paragraph .12

## Relationship of the Specialist to the Client

**.10** The auditor should evaluate the relationship<sup>6</sup> of the specialist to the client, including circumstances that might impair the specialist's objectivity. Such circumstances include situations in which the client has the ability—through employment, ownership, contractual right, family relationship, or otherwise—to directly or indirectly control or significantly influence the specialist.

**.11** When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. However, the work of a specialist who has a relationship with the client may be acceptable under certain circumstances. If the specialist has a relationship with the client, the auditor should assess the risk that the specialist's objectivity might be impaired. If the auditor believes the relationship might impair the specialist's objectivity, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should engage another specialist for that purpose.

## Using the Findings of the Specialist

**.12** The appropriateness and reasonableness of methods and assumptions used and their application are the responsibility of the specialist. The auditor should (a) obtain an understanding of the methods and assumptions used by the specialist, (b) make appropriate tests of data provided to the specialist, taking into account the auditor's assessment of control risk, and (c) evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor's procedures lead him or her to believe the findings are unreasonable in the circumstances. If the auditor believes the findings are unreasonable, he or she should apply additional procedures, which may include obtaining the opinion of another specialist.

## Effect of the Specialist's Work on the Auditor's Report

**.13** If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude

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<sup>5</sup> In some cases, the auditor may decide it is necessary to contact the specialist to determine that the specialist is aware that his or her work will be used for evaluating the assertions in the financial statements.

<sup>6</sup> The term *relationship* includes, but is not limited to, those situations discussed in section 334, *Related Parties*, footnote 1.

that sufficient appropriate audit evidence has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate audit evidence as to an assertion of material significance in the financial statements constitutes a scope limitation. (See section 508, *Reports on Audited Financial Statements*, paragraphs .22 and .23.) [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.14** The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (See section 508.35, .36, and .41.)

### Reference to the Specialist in the Auditor's Report

**.15** Except as discussed in paragraph .16, the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

**.16** The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.

### Effective Date

**.17** This section is effective for audits of periods ending on or after December 15, 1994. Early application of the provisions of this section is encouraged.

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## AU Section 328

# *Auditing Fair Value Measurements and Disclosures*

Source: SAS No. 101; SAS No. 113.

Effective for audits of financial statements for periods beginning on or after June 15, 2003, unless otherwise indicated.

See section 9328 for interpretations of this section.

### Introduction

**.01** The purpose of this section is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, this section addresses audit considerations relating to the measurement and disclosure of assets, liabilities, and specific components of equity presented or disclosed at fair value in financial statements. Fair value measurements of assets, liabilities, and components of equity may arise from both the initial recording of transactions and later changes in value. Changes in fair value measurements that occur over time may be treated in different ways under generally accepted accounting principles (GAAP). For example, GAAP may require that some fair value changes be reflected in net income and that other fair value changes be reflected in other comprehensive income and equity.

**.02** While this section provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to the measurement and disclosure of fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation, such as the physical condition of the asset.

**.03** The auditor should obtain sufficient appropriate audit evidence to provide reasonable assurance that fair value measurements and disclosures are in conformity with GAAP. GAAP requires that certain items be measured at fair value. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) glossary term *fair value* is defined 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.<sup>1</sup> Although GAAP may not prescribe the method for measuring the fair value of an item, it expresses a preference for the use of observable market prices to make that determination. In the absence of observable market prices, GAAP requires fair value to be based on the best information available in the circumstances.

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<sup>1</sup> Governmental Accounting Standards Board Statement of Governmental Accounting Standards No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, defines *fair value* as "the amount at which an investment could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale." [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

[Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105. Revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

**.04** Management is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, management needs to establish an accounting and financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and ensure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

**.05** Fair value measurements for which observable market prices are not available are inherently imprecise. That is because, among other things, those fair value measurements may be based on assumptions about future conditions, transactions, or events whose outcome is uncertain and will therefore be subject to change over time. The auditor's consideration of such assumptions is based on information available to the auditor at the time of the audit. The auditor is not responsible for predicting future conditions, transactions, or events that, had they been known at the time of the audit, may have had a significant effect on management's actions or management's assumptions underlying the fair value measurements and disclosures.<sup>2</sup>

**.06** Assumptions used in fair value measurements are similar in nature to those required when developing other accounting estimates. However, if observable market prices are not available, GAAP requires that valuation methods incorporate assumptions that marketplace participants would use in their estimates of fair value whenever that information is available without undue cost and effort. If information about market assumptions is not available, an entity may use its own assumptions as long as there are no contrary data indicating that marketplace participants would use different assumptions. These concepts generally are not relevant for accounting estimates made under measurement bases other than fair value. Section 342, *Auditing Accounting Estimates*, provides guidance on auditing accounting estimates in general. This section addresses considerations similar to those in section 342 as well as others in the specific context of fair value measurements and disclosures in accordance with GAAP.

**.07** GAAP requires or permits a variety of fair value measurements and disclosures in financial statements. GAAP also varies in the level of guidance that it provides on measuring fair values and disclosures. While this section provides guidance on auditing fair value measurements and disclosures, it does not address specific types of assets, liabilities, components of equity, transactions, or industry-specific practices.<sup>3</sup>

**.08** The measurement of fair value may be relatively simple for certain assets or liabilities, for example, investments that are bought and sold in active markets that provide readily available and reliable information on the prices at which actual exchanges occur. For those items, the existence of published

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<sup>2</sup> For purposes of this section, management's assumptions include assumptions developed by management under the guidance of those charged with governance and assumptions developed by a specialist engaged or employed by management. [Footnote revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

<sup>3</sup> See, for example, section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

price quotations in an active market is the best evidence of fair value. The measurement of fair value for other assets or liabilities may be more complex. A specific asset may not have an observable market price or may possess such characteristics that it becomes necessary for management to estimate its fair value based on the best information available in the circumstances (for example, a complex derivative financial instrument). The estimation of fair value may be achieved through the use of a valuation method (for example, a model premised on discounting of estimated future cash flows).

## Understanding the Entity's Process for Determining Fair Value Measurements and Disclosures and the Relevant Controls, and Assessing Risk

**.09** The auditor should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant controls sufficient to develop an effective audit approach.

**.10** Management is responsible for establishing an accounting and financial reporting process for determining fair value measurements. In some cases, the measurement of fair value and therefore the process set up by management to determine fair value may be simple and reliable. For example, management may be able to refer to published price quotations in an active market to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process.

**.11** Section 314, *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*, requires the auditor to obtain an understanding of each of the five components of internal control sufficient to assess the risk of material misstatement. In the specific context of this section, the auditor obtains such an understanding related to the determination of the entity's fair value measurements and disclosures in order to plan the nature, timing, and extent of the audit procedures. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

**.12** When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example:

- Controls over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role that information technology has in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from nonroutine or unusual transactions).
- The extent to which the entity's process relies on a service organization to provide fair value measurements or the data that supports the measurement. When an entity uses a service organization, the auditor

considers the requirements of section 324, *Service Organizations*, as amended.

- The extent to which the entity engages or employs specialists in determining fair value measurements and disclosures.
- The significant management assumptions used in determining fair value.
- The documentation supporting management's assumptions.
- The process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.
- The process used to monitor changes in management's assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness, and reliability of the data used in valuation models.

**.13** The auditor uses his or her understanding of the entity's process, including its complexity, and of the controls when assessing the risk of material misstatement. Based on that risk assessment, the auditor determines the nature, timing, and extent of the audit procedures. The risk of material misstatement may increase as the accounting and financial reporting requirements for fair value measurements become more complex.

**.14** Section 314 discusses the inherent limitations of internal control. As fair value determinations often involve subjective judgments by management, this may affect the nature of controls that are capable of being implemented, including the possibility of management override of controls (see section 316, *Consideration of Fraud in a Financial Statement Audit*). The auditor considers the inherent limitations of internal control in such circumstances in assessing control risk. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 109.]

## Evaluating Conformity of Fair Value Measurements and Disclosures With GAAP

**.15** The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP. The auditor's understanding of the requirements of GAAP and knowledge of the business and industry, together with the results of other audit procedures, are used to evaluate the accounting for assets or liabilities requiring fair value measurements, and the disclosures about the basis for the fair value measurements and significant uncertainties related thereto.

**.16** The evaluation of the entity's fair value measurements and of the audit evidence depends, in part, on the auditor's knowledge of the nature of the business. This is particularly true where the asset or liability or the valuation method is highly complex. For example, derivative financial instruments may be highly complex, with a risk that differing assumptions used in determining fair values will result in different conclusions. The measurement of the fair value of some items, for example "in process research and development" or intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations. Also, the auditor's knowledge of the business, together with the results of other audit

procedures, may help identify assets for which management should assess the need to recognize an impairment loss under applicable GAAP.

**.17** The auditor should evaluate management's intent to carry out specific courses of action where intent is relevant to the use of fair value measurements, the related requirements involving presentation and disclosures, and how changes in fair values are reported in financial statements. The auditor also should evaluate management's ability to carry out those courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and GAAP may require it to do so. While the extent of evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:

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

**.18** When there are no observable market prices and the entity estimates fair value using a valuation method, the auditor should evaluate whether the entity's method of measurement is appropriate in the circumstances. That evaluation requires the use of professional judgment. It also involves obtaining an understanding of management's rationale for selecting a particular method by discussing with management its reasons for selecting the valuation method. The auditor considers whether:

- a. Management has sufficiently evaluated and appropriately applied the criteria, if any, provided by GAAP to support the selected method.
- b. The valuation method is appropriate in the circumstances given the nature of the item being valued.
- c. The valuation method is appropriate in relation to the business, industry, and environment in which the entity operates.

Management may have determined that different valuation methods result in a range of significantly different fair value measurements. In such cases, the auditor evaluates how the entity has investigated the reasons for these differences in establishing its fair value measurements.

**.19** The auditor should evaluate whether the entity'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 entity, or changes in accounting principles. If management has changed the method for determining fair value, the auditor considers whether management can adequately demonstrate that the method to which it has changed provides a more appropriate basis of measurement or whether the change is supported by a change in the GAAP requirements or a change in circumstances.<sup>4</sup> For example, the introduction of an active market

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<sup>4</sup> Paragraphs 1–2 of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 250-10-45 state that a presumption exists that an accounting principle once adopted shall not be changed in accounting for events and transactions of a similar type. Consistent use of the same accounting principle from one accounting period to another enhances the utility of financial

(continued)

for an equity security may indicate that the use of the discounted cash flows method to estimate the fair value of the security is no longer appropriate.

## Engaging a Specialist

**.20** The auditor should consider whether to engage a specialist and use the work of that specialist as audit evidence in performing substantive tests to evaluate material financial statement assertions. The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or may decide to use the work of a specialist. If the use of such a specialist is planned, the auditor should consider the guidance in section 336, *Using the Work of a Specialist*. [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.21** When planning to use the work of a specialist in auditing fair value measurements, the auditor considers whether the specialist's understanding of the definition of fair value and the method that the specialist will use to determine fair value are consistent with those of management and with GAAP. For example, the method used by a specialist for estimating the fair value of real estate or a complex derivative may not be consistent with the measurement principles specified in GAAP. Accordingly, the auditor considers such matters, often through discussions with the specialist or by reading the report of the specialist.

**.22** Section 336 provides that, while the reasonableness of assumptions and the appropriateness of the methods used and their application are the responsibility of the specialist, the auditor obtains an understanding of the assumptions and methods used. However, if the auditor believes the findings are unreasonable, he or she applies additional procedures as required in section 336.

## Testing the Entity's Fair Value Measurements and Disclosures

**.23** Based on the auditor's assessment of the risk of material misstatement, the auditor should test the entity's fair value measurements and disclosures. 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. For example, substantive tests of the fair value measurements may involve (a) testing management's significant assumptions, the valuation model, and the underlying data (see paragraphs .26 through .39), (b) developing independent fair value estimates for corroborative purposes (see paragraph .40), or (c) reviewing subsequent events and transactions (see paragraphs .41 and .42).

**.24** Some fair value measurements are inherently more complex than others. This complexity arises either because of the nature of the item being measured at fair value or because of the valuation method used to determine fair value. For example, in the absence of quoted prices in an active market, an estimate of a security's fair value may be based on valuation methods such as the

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*(footnote continued)*

statements for users by facilitating analysis and understanding of comparative accounting data. A reporting entity shall change an accounting principle only if either of the following apply:

- a. The change is required by a newly issued codification update.
- b. The entity can justify the use of an allowable alternative accounting principle on the basis that it is preferable.

[Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

discounted cash flow method or the transactions method. Complex fair value measurements normally are characterized by greater uncertainty regarding the reliability of the measurement process. This greater uncertainty may be a result of:

- The length of the forecast period
- The number of significant and complex assumptions associated with the process
- A higher degree of subjectivity associated with the assumptions and factors used in the process
- A higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used
- Lack of objective data when highly subjective factors are used

**.25** The auditor uses both the understanding of management's process for determining fair value measurements and his or her assessment of the risk of material misstatement to determine the nature, timing, and extent of the audit procedures. The following are examples of considerations in the development of audit procedures:

- The fair value measurement (for example, a valuation by an independent appraiser) may be made at a date that does not coincide with the date at which the entity is required to measure and report that information in its financial statements. In such cases, the auditor obtains evidence that management has taken into account the effect of events, transactions, and changes in circumstances occurring between the date of the fair value measurement and the reporting date.
- Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible impairment. If the collateral is an important factor in measuring the fair value of the investment or evaluating its carrying amount, the auditor obtains sufficient appropriate audit evidence regarding the existence, value, rights, and access to or transferability of such collateral, including consideration of whether all appropriate liens have been filed, and considers whether appropriate disclosures about the collateral have been made.
- In some situations, additional procedures, such as the inspection of an asset by the auditor, may be necessary to obtain sufficient appropriate audit evidence about the appropriateness of a fair value measurement. For example, inspection of the asset may be necessary to obtain information about the current physical condition of the asset relevant to its fair value, or inspection of a security may reveal a restriction on its marketability that may affect its value.

[Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

### **Testing Management's Significant Assumptions, the Valuation Model, and the Underlying Data**

**.26** The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of audit

procedures. When testing the entity's fair value measurements and disclosures, the auditor evaluates whether:

- a. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).
- b. The fair value measurement was determined using an appropriate model, if applicable.
- c. Management used relevant information that was reasonably available at the time.

**.27** Estimation methods and assumptions, and the auditor's consideration and comparison of fair value measurements determined in prior periods, if any, to results obtained in the current period, may provide evidence of the reliability of management's processes. However, the auditor also considers whether variances from the prior-period fair value measurements result from changes in market or economic circumstances.

**.28** Where applicable, the auditor should evaluate whether the significant assumptions used by management in measuring fair value, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements.

**.29** Assumptions are integral components of more complex valuation methods, for example, valuation methods that employ a combination of estimates of expected future cash flows together with estimates of the values of assets or liabilities in the future, discounted to the present. Auditors pay particular attention to the significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable and reflect, or are not inconsistent with, market information (see paragraph .06).

**.30** Specific assumptions will vary with the characteristics of the item being valued and the valuation approach used (for example, cost, market, or income). For example, where the discounted cash flows method (a method under the income approach) is used, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.

**.31** Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor evaluates the source and reliability of evidence supporting management's assumptions, including consideration of the assumptions in light of historical and market information.

**.32** Audit procedures dealing with management's assumptions are performed in the context of the audit of the entity's financial statements. The objective of the audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an opinion on the assumptions themselves. Rather, the auditor performs procedures to evaluate whether the assumptions provide a reasonable basis for measuring fair values in the context of an audit of the financial statements taken as a whole. [Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.33** Identifying those assumptions that appear to be significant to the fair value measurement requires the exercise of judgment by management. The auditor focuses attention on the significant assumptions that management has identified. Generally, significant assumptions cover matters that materially affect the fair value measurement and may include those that are:

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

to significant variation compared to assumptions about long-term interest rates.

- b. Susceptible to misapplication or bias.

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

**.35** The evaluation of whether the assumptions provide a reasonable basis for the fair value measurements relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent and therefore need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value.

**.36** To be reasonable, the assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows),<sup>5</sup> individually and taken as a whole, need to be realistic and consistent with:

- a. The general economic environment, the economic environment of the specific industry, and the entity's economic circumstances;
- b. Existing market information;
- c. The plans of the entity, including what management expects will be the outcome of specific objectives and strategies;
- d. Assumptions made in prior periods, if appropriate;
- e. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;
- f. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and
- g. The risk associated with cash flows, if applicable, including the potential variability in the amount and timing of the cash flows and the related effect on the discount rate.

Where assumptions are reflective of management's intent and ability to carry out specific courses of action, the auditor considers whether they are consistent with the entity's plans and past experience.

**.37** If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events, for example, if management intends to engage in new activities or circumstances change.

**.38** For items valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor reviews the model and evaluates whether the assumptions used are reasonable and

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<sup>5</sup> The auditor also should consider requirements of FASB ASC 820, *Fair Value Measurements and Disclosures*. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

the model is appropriate considering the entity's circumstances. For example, it may be inappropriate to use discounted cash flows for valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows.

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

### Developing Independent Fair Value Estimates for Corroborative Purposes

**.40** The auditor may make an independent estimate of fair value (for example, by using an auditor-developed model) to corroborate the entity's fair value measurement.<sup>6</sup> When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed in paragraphs .28 to .37. Instead of using management's assumptions, the auditor may develop his or her own assumptions to make a comparison with management's fair value measurements. In that situation, the auditor nevertheless understands management's assumptions. The auditor uses that understanding to ensure that his or her independent estimate takes into consideration all significant variables and to evaluate any significant difference from management's estimate. The auditor also should test the data used to develop the fair value measurements and disclosures as discussed in paragraph .39.

### Reviewing Subsequent Events and Transactions

**.41** Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date) may provide audit evidence regarding management's fair value measurements as of the balance-sheet date.<sup>7</sup> In such circumstances, the audit procedures described in paragraphs .26 through .40 may be minimized or unnecessary because the subsequent event or transaction can be used to substantiate the fair value measurement. [As amended, effective for audits of financial statements for periods ending on or after December 15, 2006, by Statement on Auditing Standards No. 113.]

**.42** Some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet date and thus do not constitute appropriate audit evidence of the fair value measurement at the balance-sheet date (for example, the prices of actively traded marketable securities that change after the balance-sheet date). When using a subsequent event or transaction to

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<sup>6</sup> See section 329, *Analytical Procedures*.

<sup>7</sup> The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, *Subsequent Events*.

substantiate a fair value measurement, the auditor considers only those events or transactions that reflect circumstances existing at the balance-sheet date.

## Disclosures About Fair Values

**.43** The auditor should evaluate whether the disclosures about fair values made by the entity are in conformity with GAAP.<sup>8</sup> Disclosure of fair value information is an important aspect of financial statements. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity's performance and financial position. In addition to the fair value information required under GAAP, some entities disclose voluntary additional fair value information in the notes to the financial statements.

**.44** When auditing fair value measurements and related disclosures included in the notes to the financial statements, whether required by GAAP or disclosed voluntarily, the auditor ordinarily performs essentially the same types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements. The auditor obtains sufficient appropriate audit evidence that the valuation principles are appropriate under GAAP and are being consistently applied, and that the method of estimation and significant assumptions used are adequately disclosed in accordance with GAAP. [Revised, March 2008, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 105.]

**.45** The auditor evaluates whether the entity has made adequate disclosures about fair value information. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty.<sup>9</sup>

**.46** When disclosure of fair value information under GAAP is omitted because it is not practicable to determine fair value with sufficient reliability, the auditor evaluates the adequacy of disclosures required in these circumstances. If the entity has not appropriately disclosed fair value information required by GAAP, the auditor evaluates whether the financial statements are materially misstated.

## Evaluating the Results of Audit Procedures

**.47** The auditor should evaluate the sufficiency and competence of the audit evidence obtained from auditing fair value measurements and disclosures as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. The auditor's evaluation of whether the fair value measurements and disclosures in the financial statements are in conformity with GAAP is performed in the context of the financial statements taken as a whole (see section 312, *Audit Risk and Materiality in Conducting an Audit*, paragraphs .50 through .61). [Revised, March 2006, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 107.]

## Management Representations

**.48** Section 333, *Management Representations*, requires that the independent auditor obtain written representations from management as a part of an audit of financial statements performed in accordance with generally accepted

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<sup>8</sup> See also section 431, *Adequacy of Disclosure in Financial Statements*.

<sup>9</sup> See FASB ASC 275, *Risks and Uncertainties*. [Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC.]

auditing standards and provides guidance concerning the representations to be obtained. The auditor ordinarily should obtain written representations from management regarding the reasonableness of significant assumptions, including whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the use of fair value measurements or disclosures.

**.49** Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair value and the consistency in application of the methods.
- The completeness and adequacy of disclosures related to fair values.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

## Communication With Those Charged With Governance

**.50** Section 380, *The Auditor's Communication With Those Charged With Governance*, requires auditors to determine that certain matters related to the conduct of an audit are communicated to those charged with governance. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements, the degree of subjectivity involved in the development of the assumptions, and the relative materiality of the items being measured at fair value to the financial statements as a whole. The auditor considers the guidance contained in section 380 when determining the nature and form of communication. [Revised, April 2007, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 114.]

## Effective Date

**.51** This section is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application of the provisions of this section is permitted.

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