

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 4-5, 2008

Fair Value Auditing Guidance Task Force

Objective of Agenda Item

1. The objectives of this agenda item are:
 - (a) To report on the main outcomes of the March 2008 and June 2008 IAASB meetings;
 - (b) To report on the discussions and activities of the Task Force to date; and
 - (c) To obtain the Representatives' views on topics that are currently under consideration by the Task Force for further development.

Task Force

2. The members of the Task Force are:

John Fogarty (Chair)	IAASB Member
Doug Besch	External Member
Susan Koski-Grafer	External Member
Marc Pickeur	External Member
Tom Ray	External Member
Patricia Sucher	External Member
Chris Taylor	External Member
John Kellas (ex-officio)	IAASB Chair

As work progresses on the various initiatives, the composition of the task force may be increased or modified depending on the expertise that is needed. In addition, a wider group of interested parties, including auditors, regulators, preparers and investors has also been consulted to inform the discussion of the task force and provide feedback on activities that the IAASB could pursue in developing possible auditing guidance on fair value accounting estimates. (See paragraphs 13-14 below.)

Background

3. In February 2008, the IAASB announced that it had established a Task Force to consider how best to approach the development of possible further fair value auditing guidance. This was done to address some of the valuation difficulties highlighted by the problems in the world's

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major financial markets, many of which were raised by respondents who commented on the exposure draft of ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

4. The Financial Stability Forum (FSF) prepared a report dated 7 April 2008 to the G7 on Enhancing Market and Institutional Resilience. Among the recommendations of the FSF was that “The IAASB, major national audit standard setters and relevant regulators should consider the lessons learned during the market turmoil and, where necessary, enhance the guidance for audits of valuations of complex or illiquid financial products and related disclosures.”
5. As the IAASB had already established a task force to consider the issuance of fair value auditing guidance, this Task Force was asked to consider ways in which any activities it might undertake would respond to the recommendation from the FSF. The Task Force considers that activities to engage auditors (as discussed in paragraphs 6-12 below) as well as the reminder of relevant material in ISAs highlighting the challenges in auditing fair values when markets lack liquidity (described as an “Alert” and discussed in paragraphs 19-21 below) would be appropriate responses to the FSF’s recommendations.

Main Outcomes of March 2008 and June 2008 IAASB Discussions

Auditor Interviews

6. The IAASB strongly supported the point highlighted by the CAG Representatives during their March 2008 CAG meeting that the IAASB should undertake to consider the lessons to be learned from auditors’ experience in the past audit season. The IAASB agreed to approach auditors to seek their input on areas where further guidance could be issued in the interest of achieving consistency in performance and use this as a basis for determining what, if anything, should be done by the IAASB.
7. The Chair and staff of the IAASB Fair Value Auditing Guidance Task Force undertook, on behalf of the Task Force, a series of interviews of Big 4 auditors who were significantly involved in fair value issues related to investments during the 2007 and early 2008 period. Some of these auditors had central roles in consultation and review of fair value issues. Others were engagement partners for audits of large entities which had significant investment holdings. Those interviewed had a high degree of consistency of experience, and were primarily from the US, UK and Canada.
8. The purpose of these interviews was to identify areas that these auditors believed needed further guidance and any other actions that would improve the effectiveness of audits of fair values.

Matters of Interest

9. A few recurring themes were noted during the discussions:

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- Preparers and auditors cited difficulties in obtaining appropriate information to support an understanding of how fair values are determined when there is no observable market price and little information available to support the valuation, such as when pricing services and broker quotes were used.
- All participants indicated difficulties auditing valuing assets without readily available market prices.
- While the firms were able to develop an approach to obtaining this information, these efforts unlikely to be sustainable for future audit seasons.

Areas for Possible IAASB Involvement

10. Three main areas were suggested for further exploration by the Task Force:

- Education and awareness – Those interviewed believed that preparers and auditors are working to improve in relation to the skills, confidence, education, and familiarity with terms and approaches to prepare a valuation, on both the preparer and auditor side, however, more could be done in these areas. They suggested there is a need for dissemination of basic reference material. While the firms have training activities underway, a plain man's guide to such information would be helpful.
- Pricing services – There is a need for information on how pricing services compute prices, in particular the methods used to compile them. Clients that are bigger customers of pricing services have more access to this information, but there could be a role for the IAASB to help facilitate a broader dissemination of this information.
- Alerts similar to what was done by the Global Public Policy Committee, the U.S. Public Company Accounting Oversight Board and the UK Auditing Practices Board – This could promote awareness of current challenges with fair values and also remind others that fair values are also relevant with regard to endowments, universities and hospitals.

11. Those who were interviewed believed that the auditing standards themselves are quite adequate, and it would not be necessary for another standard to be developed.

12. Regarding timing, it was suggested that any activities be undertaken as soon as possible so that at least some is available for the next audit season. Groups such as the Financial Executives Institute or perhaps IFAC member bodies could be involved in the development of any basic reference material; it was agreed that such a task would likely need to involve more than IFAC staff.

Task Force Activities to Date

13. After the IAASB discussions in June, it was determined that it would be helpful to reconvene a meeting with those participants who had provided initial input to the Task Force during a February 2008 Information Gathering Meeting. The follow-up teleconference was held on July 1; the goal of the discussions was to gather recommendations of the group about what activities could be pursued, who the audience was for these activities, and whether there was a

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role for the IAASB to lead or participate in these activities. The discussions of this group were broadly consistent with the discussions held with auditors and served to inform the task force on the way forward.

14. In brief summary the group recommended that:

- High quality basic information about credit markets, instruments, fair value concepts, pricing approaches, how pricing services work, terms and acronyms etc. should be developed and provided (plain man's guide).
- A dialogue between pricing services, brokers, preparers and auditors about how best to provide information about prices to enable preparers and auditors to have an adequate understanding of pricing of illiquid investments should be created.
- An alert on application of the auditing standards relevant to fair value be prepared.
- Further consideration be given to providing guidance similar to that issued by the US ASB on auditing investments in private equity funds through the use of confirmations and reporting on funds that do not disclose the individual investments they have made.
- The scope of the work of the Fair Value Auditing Guidance Task Force should also include applications of fair value broadly, not just with respect to financial assets and liabilities.
- Consideration be given to whether sufficient audit input is being provided to the IASB Expert Advisory Panel.

15. The Task Force has initially discussed each of the recommendations above and believes that this course of action is appropriate. The IAASB will consider the recommendations at its upcoming meeting and advise the Task Force of the way forward. Certain of the projects may require a formal project proposal to be developed, depending on the expected outcome (for example, if an IAPS is to be developed.) Each of the recommendations, and the progress of the Task Force to date, is set forth below.

Development of a Plain Man's Guide

16. It was suggested that a particular IFAC member body may wish to be involved in preparing the plain man's guide, and initial contact has been made. While the reaction was positive, a more considered response is awaited. There may also be other interested parties who could be approached. Meanwhile, some thought has been given to how such a guide may be presented.
17. It may be best for the plain man's guide to initially be focused on certain key areas, with the thought that further topics could be added in the future based on the need to do so and a prioritization of topics. It was suggested that there are a number of resources / other publications that could be linked into the guide that would serve as helpful references, such as work from the US Securities and Exchange Commission and others.

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Dialogue with Pricing Services

18. This initiative is in the early stages of exploration. The heads of the professional practices of the Big 4 have been asked to activate a group of their fair value experts to discuss how dialogue with the pricing services could be facilitated.

Alert on Relevant Guidance in Existing Standards

19. The Task Force agreed that the development of an alert that could be broadly disseminated would be useful. The alert would be issued as a staff document to assist auditors by highlighting areas within the ISAs that are particularly relevant in the audit of fair value accounting estimates in times of market uncertainty.
20. The Task Force has discussed preliminary drafts of the alert, and has agreed broadly to the form and content of the alert. It was also agreed that, to the extent possible, the alert should direct auditors to ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures," bearing in mind that the ISA is not yet effective. Since some of the matters discussed in the application and other explanatory material of ISA 540 (Revised and Redrafted) were influenced by the changes in the credit markets that had become apparent immediately before the new ISA was finalized, the ISA includes guidance that is likely to be useful to auditors planning their 2008 engagement. There was support from the Task Force that, unless such guidance was associated with a completely new requirement in the new standard, this guidance could be incorporated into the alert. A similar reference to the revised and redrafted ISA had been made in the press release announcing its release and the formation of the Task Force.
21. The IAASB Steering Committee has also reviewed a draft of the alert, and the IAASB will be given some opportunity to comment on the alert before its publication though it will remain a staff document. The final version of the alert will be issued in electronic form and if possible will contain hyperlinks to the requirements in the extant standards. It is anticipated that this alert will be issued in late September 2008, in order to allow auditors to refer to it in planning for the 2008 audit season.

Investments and the Use of Confirmations, Including Hedge Funds

22. The Task Force had been briefed about auditing interpretations that had been issued by the AICPA that provide authoritative guidance about whether it is appropriate to obtain evidence about the valuation of investments through confirmations, and the auditor's actions when auditing financial statements of funds that do not disclose their individual investments. While not every financial reporting framework may require this type of disclosure, it may still be useful to auditors to alert them to the need to obtain sufficient appropriate audit evidence.
23. The Task Force questioned whether there was anything in the ISAs at present that would address this point; in relation to the funds' financial statements, the point had previously been discussed in the context of modified opinions and the auditor's responsibility to include omitted disclosures in the auditor's report. Because there is currently no guidance in the ISAs

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on this matter, it may not be possible to address it in the planned alert unless there is something in the current standards to which it could be linked.

24. If such guidance were to be developed, it would likely need to be exposed for public comment. This could perhaps take the form of an IAPS, and would require approximately 18 months to be developed. The work program included in the IAASB's future strategy included time for a formal project arising from the Task Force's recommendations to be developed.
25. In the US, a practice aid for auditors had been developed to expand upon the interpretation relating to alternative investments. It was noted by a Task Force member that there is awareness that problems had been encountered in practice in this area.
26. The IAASB intends to further discuss whether a formal project on this topic is considered necessary at its September 2008 meeting.

Scope of the Work of the Fair Value Auditing Guidance Task Force

27. The Task Force will consider this recommendation for each of the projects it undertakes, as appropriate. The proposed alert notes that it is intended to draw auditors' attention to matters that are relevant in light of current difficulties in the current markets and therefore has a focus on financial instruments, however, it also highlights to more widespread use of fair value for examples in the determination of pension liabilities, the value of goodwill and intangibles acquired in a business combination, real estate, endowment funds, share-based payments, non-monetary exchanges and other classes of assets and liabilities.

Liaison with IASB Expert Advisory Panel

28. The IASB Expert Advisory Panel, a group that includes representatives from the Big 4, industry and regulators, is currently determining whether practice guidance could be developed to address valuation methods for financial instruments when markets are no longer active, and is also reviewing best practices in the area of valuation techniques.
29. Mr. Kellas had planned to liaise with the IASB on deepening the interaction between the IASB and IAASB in general, as envisaged in the IAASB strategy and discussions at the March 2008 IAASB CAG Meeting, and this has presented an opportunity for doing so. It was agreed that the IASB and IAASB should interact where possible on each other's respective projects. Mr. Kellas has attended meetings of the working group on behalf of the Task Force.
30. At present, it is likely that any product to be issued by this working group would not be officially issued as an IASB document. It is likely that any product (at least in draft) will be available on its website by mid-September. It has been suggested that IAASB Staff seek to coordinate the timing of the proposed alert with the issuance of the IASB document, and provide a link on the IAASB's website to the IASB's website.

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Further Coordination with Auditors

31. A formal letter will be sent to the Big 4 firms to confirm that someone with relevant knowledge and experience has reviewed ISA 540 (Revised and Redrafted) and confirmed that it is consistent with the procedures they followed in the past audit season, to ensure the completeness of the new standard.
32. The Task Force agreed that further coordination with the Forum of Firms (FoF) would be useful in obtaining additional views about the experience of auditors. A portion of the planned FoF meeting in October 2008 (involving audit firms of varying sizes) will be dedicated to a dialogue with auditors to facilitate best practices and discuss issues encountered in practice. The usual participants in the meeting have been invited to bring along those with relevant expertise, whether in fair values broadly, financial instruments or financial institutions, or perhaps those involved in consultation or the development of audit methodology. Such a session is intended as an educational opportunity for some of the smaller firms that may not have experts in fair value. At present, the technical expert panel intends to cover going concern, valuation, and consolidations and off-balance sheet transactions. A session has also been scheduled for the IAASB to present.

Action Requested

The CAG Representatives are asked for their views on actions described above, including the priority of each action.