STAFF AUDIT PRACTICE ALERT

IAASB INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD

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The IAASB is an independent standard-setting board of the International Federation of Accountants.

CHALLENGES IN AUDITING FAIR VALUE ACCOUNTING ESTIMATES IN THE CURRENT MARKET ENVIRONMENT

This alert is issued by staff of the International Auditing and Assurance Standards Board (IAASB) to assist auditors by highlighting areas within the International Standards on Auditing (ISAs) that are particularly relevant in the audit of fair value accounting estimates[1] in times of market uncertainty. It has been prepared in light of current difficulties in the credit markets and therefore has a focus on financial instruments. It also refers to related issues concerning whether an entity has the ability to continue as a going concern. **The alert is relevant to audits of all entities that have investments in financial instruments, especially those in illiquid markets.**

The alert does not amend or override the ISAs that are currently effective, the texts of which alone are authoritative. The alert is intended to remind auditors of certain of their obligations under those standards. While certain ISAs are highlighted, the alert is not meant to be exhaustive and reference to the ISAs themselves should always be made. In conducting an audit in accordance with ISAs, auditors are required to comply with *all* the ISAs that are relevant to the engagement.[2]

This alert discusses:

- Challenges faced in accounting on the basis of fair value;
- Requirements and guidance in standards that are particularly relevant to fair values;
- Other considerations in audits of fair value accounting estimates;
- Initiatives of the International Accounting Standards Board; and
- Recent revisions to extant standards on auditing accounting estimates and fair value measurements and disclosures which, while not yet effective, may be helpful to auditors.

Background

Measurement and disclosure of fair values are of great importance in many financial reporting frameworks. Auditors are expected to be aware of the need to understand the accounting principles and rules relating to accounting on the basis of fair value, including disclosures, and to give appropriate consideration to their application.

Recent market experience has highlighted the difficulties that arise in valuing financial instruments when market information is either not available or sufficient information is difficult to obtain. Many regulatory and other organizations[3] have been considering how best to assist preparers of financial statements and their auditors to deal with these difficulties; users, preparers and auditors may also benefit from guidance issued in their jurisdictions aimed at raising awareness of the challenges faced in light of current market conditions, including the "credit crunch" and reduced market liquidity.

The Financial Stability Forum (FSF) prepared a report[4] dated 7 April 2008 to the G7 Finance Ministers proposing actions in the following areas:

- Strengthened prudential oversight of capital, liquidity and risk management.

1 An accounting estimate is defined in the ISAs as "an approximation of a monetary amount in the absence of a precise means of measurement." This term is used for an amount measured at fair value when there is estimation uncertainty, as well as for other amounts that require estimation. Fair value is defined in the ISAs as "the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction."

2 The complete set of ISAs that are currently effective are available for download at **http://www.ifac.org/Members/DownLoads/2008_IAASB_Handbook_Part_I-Compilation.pdf**.

3 See last section of this alert for the work of the IASB's expert advisory panel.

4 "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" (Report of the FSF).

- Enhancing transparency and valuation.
- Changes in the role and uses of credit ratings.
- Strengthening the authorities' responsiveness to risks.
- Robust arrangements for dealing with stress in the financial system.

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]

The IAASB had already established a task force in February 2008 to consider whether additional guidance on fair values was necessary and that task force was also asked to develop a response to the FSF recommendation. The task force includes representatives of auditors and regulators. A wider group of interested parties, including preparers and investors, has also been consulted to inform the discussions of the task force and provide feedback on activities that the IAASB could pursue in developing possible auditing guidance on fair value accounting estimates. The task force recommended that a reminder of relevant material in ISAs should be issued. This alert has been prepared in response to that recommendation.

Challenges of Fair Value Accounting

The definition of fair value in the ISAs, as noted in footnote 1, draws upon International Accounting Standard (IAS) 39.[6] The Appendix to ISA 545 discusses fair value measurements and disclosures under different financial reporting frameworks and the prevalence of fair value measurements, including the fact that different definitions of "fair value" may exist under such frameworks.

The following matters are particularly important for preparers and auditors in considering fair value accounting estimates:

- The measurement objective, as fair value accounting estimates are expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date;
- The need to incorporate judgments concerning significant assumptions that may be made by others such as experts employed or engaged by the entity or the auditor;
- The availability (or lack thereof) of information or evidence and its reliability;
- The breadth of assets and liabilities to which fair value accounting may be, or is required to be, applied;
- The choice and sophistication of acceptable valuation techniques and models; and
- The need for appropriate disclosure in the financial statements about measurement methods and uncertainty, especially when relevant markets are illiquid.

Of the above, in the current environment obtaining reliable information relevant to fair values has been one of the greatest challenges faced by preparers, and consequently by auditors. The nature and reliability of information available to management to support the making of a fair value accounting estimate vary widely, and thereby affect the degree of estimation uncertainty associated with that fair value. If markets become inactive, market price information becomes unavailable and estimates need to be made on the basis of other information, often using models, some of which incorporate inputs that are "unobservable."[7] The degree of estimation uncertainty therefore increases and affects, in turn, the risks of material misstatement. What may in the past have been a routine valuation problem may become the source of a significant risk.[8] In such circumstances there are limits to the infor-

5 Recommendation III.9 of the Report of the FSF.

6 IAS 39, "Financial Instruments: Recognition and Measurement."

7 "Observable inputs" are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity. "Unobservable inputs" are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

8 ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement," paragraphs 108-114 deal with significant risks.

mation that management possesses or can obtain and that therefore may be available to the auditor as audit evidence. Nevertheless, whether inputs are observable or not, preparers need to have evidence to support them, and auditors need to obtain sufficient appropriate audit evidence recognizing that the evidence may be different from what has previously been available.

Experience to date has suggested that, while estimation of fair values has proved to be extremely difficult in light of market uncertainty, it has not proved impossible to obtain sufficient information to record these fair values in financial statements.

While fair values are commonly thought to relate primarily to financial assets and financial liabilities, the use of fair value is more widespread. Depending on the financial reporting framework, the impact of fair value accounting may be seen with regard to management's 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.

Requirements and Guidance in the ISAs Relevant to Auditing Fair Value Accounting Estimates

ISA 545 is the principal standard that is directly relevant. It establishes standards and provides guidance on auditing fair value measurements and disclosures contained 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. Further, those financial instruments and other assets recorded at historical cost, but not required to be re-measured at fair value, may nevertheless require fair value consideration, depending on the financial reporting framework, for supplementary disclosure or for estimation of provisions or impairment losses. Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks. For example, some financial reporting frameworks may require that such changes be reflected directly in equity, while others may require them to be reflected in income.

The ISA deals with the overarching requirement for the auditor to obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework. Within the ISA, additional requirements tailor the requirements in other ISAs to the audit of fair value; in particular, those dealing with understanding the entity and its environment and assessing the risks of material misstatement,[9] responding to assessed risks,[10] using the work of an expert,[11] obtaining management representations,[12] and communicating with those charged with governance.[13]

ISA 300[14] requires the auditor to establish the overall audit strategy for the audit. Part of the establishment of the overall strategy involves determining the characteristics of the engagement that define its scope, such as the financial reporting framework used and industry-specific reporting requirements. In the case of audits of the financial statements of banks or where there are derivative financial instruments, in addition to the ISAs, the auditor may also look to IAPS 1006 [15] or IAPS 1012[16] for further guidance.[17]

9 ISA 315.

10 ISA 330, "The Auditor's Procedures in Response to Assessed Risks."

11 ISA 620, "Using the Work of an Expert."

12 ISA 580, "Management Representations."

13 ISA 260, "Communication of Audit Matters with Those Charged with Governance.,"

14 ISA 300, "Planning an Audit of Financial Statements," paragraph 8.

15 International Auditing Practice Statement (IAPS) 1006, "Audits of the Financial Statements of Banks."

16 IAPS 1012, "Auditing Derivative Financial Instruments."

17 IAPS 1006 and IAPS 1012 refer to earlier versions of certain ISAs, but they nevertheless contain relevant information that will be helpful to auditors. IAPS 1004, "The Relationship between Banking Supervisors and Banks' External Auditors" may also be relevant to the work of the auditor when the entity being audited operates under the oversight of a banking supervisor.

Understanding the Entity and Its Environment

For all engagements, auditors are required to obtain an understanding of the entity being audited and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.[18] This includes an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatements of the financial statements, as well as an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof. Due to the complex nature of certain financial instruments, it is vital that both the entity and the auditor understand the instruments in which the entity has invested or to which it is exposed, and the related risks.[19] The auditor's understanding of the instruments may be developed, for example, by understanding the entity's processes for investing in particular instruments and the information obtained by the entity in connection with that investment decision.

Management is responsible for establishing an accounting and financial reporting process for determining fair value measurements.[20] 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 to determine fair value for marketable securities held by the entity. Some fair value measurements, however, are inherently more complex than others and may involve significant assumptions, particularly in the absence of active markets. The auditor's understanding of the measurement process, including its complexity, helps the auditor to identify and assess the risks of material misstatement in order to determine the nature, timing and extent of the further audit procedures. ISA 545 provides additional considerations for the auditor in understanding the entity's process for determining fair value measurements and disclosures.[21]

The FSF report referred to above strongly encouraged financial institutions to establish rigorous valuation processes and make robust valuation disclosures.[22] It was suggested that "rigorous internal processes requiring critical judgment and discipline in the valuation of holding of complex or potentially illiquid securities" will benefit certain entities, better equipping them to deal with the challenges in the current market. It may therefore be appropriate for the auditor's understanding of relevant industry and regulatory factors in accordance with ISA 315 to include inquiry of management as to whether there have been discussions with supervisors or other regulators during the year about valuation practices, and whether management itself has reviewed its processes in the light of the FSF's encouragement to do so.

Designing and Performing Procedures to Respond to the Assessed Risks of Material Misstatement

The nature, timing and extent of the auditor's procedures will depend upon the susceptibility to misstatement of a fair value measurement. The auditor uses the understanding discussed above to design and implement responses to the risks of material misstatement. Factors that may influence the auditor's risk assessment with regard to financial instruments include:

- Whether the entity has control procedures in place for making investment decisions, including whether these decisions are communicated with those charged with governance.
- The level of due diligence associated with particular investments, in particular whether the auditor believes management has taken action to evaluate the risks that may arise from an instrument prior to investing in such instruments.
- The expertise of those responsible for making investment decisions.

18 ISA 315, paragraph 2.

19 ISA 315, paragraph 25.

20 ISA 545, paragraph 4.

21 ISA 545, paragraph 12.

22 Recommendation III.9 of the Report of the FSF.

- Whether the entity has the ability to subsequently value the instruments, including confirmation that there is appropriate segregation of duties between those responsible for the investment and those involved in determining the investment's valuation.
- Management's track record for assessing the risks of particular instruments.

Challenges may exist for management when fair value accounting estimates have unobservable inputs, in particular as a result of illiquid markets. Management may not have the expertise internally to value illiquid or complex financial instruments, and there may be limited sources of information available to establish their values. It may be necessary for management to make assumptions, including assumptions relied upon by management based upon the work of an expert, to develop fair value measurements for illiquid assets. 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.

The reliability of audit evidence is influenced by its source and nature. For example, management may use a broker quote to support a fair value measurement; however, when the quote is obtained from the institution that initially sold the instrument, this evidence may be less objective and may need to be supplemented with evidence from one or more other brokers or information from a pricing service.[23] Because pricing services and brokers use methods of valuation that often are not known to management or the auditor, in order to understand the nature of such information the auditor may need to obtain an understanding of how such information was developed. For example, was the value based on private trades, trades of similar instruments, or was the value based on a cash flow model or some combination of inputs? Inquiry into the nature of a broker quote is directed at its reliability and its consistency with the objective of fair value measurement.

Changes in markets may require changes in valuation approaches. Consistency is generally a desirable quality in financial information, but may be inappropriate if circumstances change. ISA 545[24] gives the example of the introduction of an active market as an illustration of changed circumstances leading to a move from valuation by model to valuation by market price. In the current environment, the changes have been in the opposite direction, as markets have become inactive. Even where models have been consistently used, there is a need to examine the continuing appropriateness of the assumptions. Further, models may have been calibrated in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress. Consequently, the degree of consistency of valuation approaches and the appropriateness of changes in approach or assumptions require audit attention.

A change in valuation approach does not, however, justify a change in the underlying measurement objective which must remain a fair value as defined in the financial reporting framework, and not a move, for example, to some suggested 'intrinsic' or 'fundamental' value.

ISA 500[25] establishes standards and provides guidance on what constitutes audit evidence, the quantity and quality of audit evidence to be obtained, and the audit procedures that the auditor uses for obtaining that audit evidence. Unless management is able to support its valuations, it will be difficult for the auditor to obtain sufficient appropriate audit evidence. However, as evidence about assumptions and the validity of models is necessarily less reliable than evidence of a market price taken from an active market, it may be necessary to look at more sources of evidence to accumulate sufficient appropriate evidence, as the quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required).[26] For example, an auditor, or an auditor's expert, may use an independent model to compare its results with those of the model used by

23 ISA 545, paragraphs 33-36, contains some relevant guidance.

24 ISA 545, paragraph 28.

25 ISA 500, "Audit Evidence."

26 ISA 500, paragraph 7.

management in order to evaluate whether the values determined by management's model is reasonable.

In addition, the auditor may consider whether external sources provide audit evidence to which the auditor could benchmark an entity's practices. For example, sources that track provisioning by institutions may provide the auditor with evidence as to whether the entity's valuations are reasonable if it has invested in similar instruments.

Using the Work of an Expert

The process of developing the overall audit strategy helps the auditor to ascertain the nature, timing and extent of resources necessary to perform the engagement. This encompasses the auditor's evaluation of the resources to be deployed for specific audit areas, such as the use of appropriately experienced team members for high risk areas or whether it is necessary to involve experts on complex matters.

In the case of fair value accounting estimates, it is necessary that the audit engagement team include one or more members sufficiently skilled and knowledgeable about fair value accounting in order to comply with the required quality control procedures.[27] It may also be necessary to ensure that expertise in fair value estimation methods is available in the team, or can be called on as required. The auditor may be aware of this need at the time an engagement is accepted, or may later determine that expertise is needed having gained an understanding of the entity and its environment. ISA 545 requires the auditor to determine the need to use the work of an expert and, when the use of such an expert is planned, the auditor complies with the requirements of ISA 620.[28]

ISA 620 establishes standards and provides guidance on using the work of an expert as audit evidence, *whether the expert is used by the entity or used by the auditor.* When using the work performed by an expert, the auditor is required to obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit.[29] ISA 620 explains that when an expert is used, the appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. However, the auditor will need to obtain an understanding of the assumptions and methods used to consider whether they are appropriate and reasonable, based on the auditor's knowledge of the business and the results of other audit procedures. This guidance is supplemented by ISA 545 which includes guidance on the use of an expert[30] and on the auditor's testing of management's significant assumptions.[31]

Management Representations

ISA 545 requires the auditor to 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 fair value measurements or disclosures.[32] Depending on the nature, materiality and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements may also include representations about the following:

- The appropriateness of the measurement methods, including related assumptions, used by management in determining fair values within the applicable financial reporting framework, and the consistency in application of the methods.
- The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value.

27 ISA 220, "Quality Control for Audits of Historical Financial Information," paragraphs 19-20.

28 ISA 545, paragraphs 29-30.

29 ISA 620, paragraph 2.

30 ISA 545, paragraphs 29-32.

31 ISA 545, paragraphs 37-49.

32 ISA 545, paragraph 63.

- The completeness and appropriateness of disclosure related to fair values under the entity's applicable financial reporting framework.
- Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

Communication with Those Charged with Governance

ISA 260 requires the auditor to communicate audit matters of governance interest arising from the audit with those charged with governance.[33] ISA 545 draws attention to the fact that because of the uncertainties associated with fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest.[34] 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. In addition, the need for appropriate controls over commitments to enter into financial instrument contracts and over the subsequent measurement processes are matters that may give rise to the need for communication with those charged with governance.

Certain audit matters of governance interest are likely to be of interest to banking supervisors, particularly when those matters may require urgent action by the supervisor.[35] In many countries, requirements concerning the auditor's communication to banking supervisors are established by law, by supervisory requirement or by formal agreement or protocol. In situations where there are no such requirements, agreements or protocols, the auditor encourages the bank's management or those charged with governance to communicate on a timely basis matters that, in the auditor's judgment, may be of urgent interest to the banking supervisor.

Disclosures about Fair Values

The auditor is required to evaluate whether the disclosures about fair values made by the entity are in accordance with its financial reporting framework.[36] In times of uncertainty, disclosures assume greater significance, and the auditor may in certain cases regard potential misstatement in disclosures as a significant risk.[37] Certain financial reporting frameworks require specific disclosures regarding uncertainties generally and specific disclosures in relation to financial instruments.[38] For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates."
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity's financial position and performance.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

33 ISA 260, paragraph 2.

34 ISA 545, paragraph 65.

35 IAPS 1004, paragraph 52.

36 ISA 545, paragraph 56-60.

37 ISA 315, paragraphs 108-114 deal with significant risks.

38 For example, International Accounting Standard (IAS) 1, "Presentation of Financial Statements," and International Financial Reporting Standard (IFRS) 7, "Financial Instruments: Disclosures."

Disclosures, although important, do not justify improper accounting or permit management to include fair value estimates in the financial statements without sufficient evidence to support them.

Other Considerations in Audits of Fair Value Accounting Estimates

The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements

ISA 240[39] requires the auditor to consider the risks of material misstatements in the financial statements due to fraud. At times of market instability, unexpected losses may arise through failure to protect the entity from extreme fluctuations in commodity prices, from unanticipated weakness in asset prices, through trading misjudgments, or for other reasons. In addition, financing difficulties create pressures on management who are concerned about the solvency of the business. Such circumstances may give rise to incentives to engage in fraudulent financial reporting: to protect personal bonuses, to hide management error, to avoid breaching borrowing limits or to avoid reporting catastrophic losses.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively. This may include inappropriately adjusting assumptions and changing judgments used to estimate account balances, for example using assumptions for fair value accounting estimates that are inconsistent with observable marketplace assumptions. In illiquid markets, the increased use of models and lack of market comparisons may present opportunities for manipulation or override of amounts calculated by brokers or experts. Even without fraudulent intent, there may be a natural temptation to bias judgments towards the most favorable end of what may be a wide spectrum. What is favorable is not always the position leading to the highest profit or lowest loss.

In auditing fair value accounting estimates, therefore, the auditor may need to consider whether the circumstances give rise to increased fraud risks. In reviewing the judgments and decisions made by management in the making of fair value accounting estimates, the auditor may identify indicators of possible management bias; if this is the case, the auditor may need to consider the implications for the rest of the audit.

The Independent Auditor's Report on Financial Statements

ISA 700[40] requires the auditor to evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements. Forming an opinion as to whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework also involves evaluating the fair presentation of the financial statements. In doing so, the auditor considers whether the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in the context of the financial reporting framework.

In certain circumstances, the auditor may determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report. ISA 701[41] describes the manner in which this would be done. ISA 701 describes an uncertainty as "a matter whose outcome depends on future actions or events not under the direct control of the entity but that may affect the financial statements." This, strictly, does not describe the type of estimation uncertainty that affects fair value measurements. Nevertheless, as indicated above, in times of uncertainty the disclosures about fair values in the financial statements may assume particular importance. However, any such emphasis is not an alternative to modification of the auditor's opinion if the auditor is not able to obtain sufficient appropriate audit evidence or disagrees with the treatment of fair values in the financial statements.

Going Concern

When planning and performing audit procedures and in evaluating the results thereof, the auditor is required

39 ISA 240, "The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements."

40 ISA 700, "The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements," paragraph 11.

41 ISA 701, "Modifications to the Independent Auditor's Report."

to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, including whether there are events or conditions and related business risks that may cast significant doubt on the entity's ability to continue as a going concern.[42] Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.[43]

When an entity is faced with deteriorating market conditions, there may be an increased risk that the entity is unable to continue as a going concern. Factors to consider include:

- The effect of significant adjustments to assets stated at fair value or requiring provisions (e.g., on covenant ratios).
- The sources of finance, and whether they will continue to be available in current market conditions.
- Changes in the cost of finance.
- The effect of changes in markets on the ability to realize assets.
- Deteriorating markets in the entity's business.
- Sale of assets at significant losses may significantly reduce regulatory capital.
- Pending legal or regulatory proceedings against an entity engaged in selling financial instruments.

The consideration of these factors may lead the auditor to conclude that a material uncertainty exists relating to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. This may require disclosures in the entity's financial statements, and an emphasis of matter in the auditor's report. In extreme cases, the auditor may disagree with the entity's basis of accounting. ISA 570 provides more guidance on the actions that may be necessary when these circumstances are present.

Initiatives of the International Accounting Standards Board

The Report of the FSF also contained a number of recommendations for the IASB.[44] In response to these recommendations, the IASB established an expert advisory panel on measurement and disclosure of fair value when markets are no longer active. The expert advisory panel includes experts from preparers and users of financial statements, as well as regulators and auditors. As explained by the IASB, the panel was asked to consider possible enhancements to the guidance on valuation and disclosures on financial instruments and on disclosures when markets are no longer active.

A draft staff summary of the panel's discussions has recently been posted on the IASB website.[45] This document provides useful information and guidance for measuring and disclosing fair values. The expert advisory panel's document does not establish new requirements for entities applying International Financial Reporting Standards (IFRSs), but entities are likely to find the guidance about the processes used and the judgments made when measuring and disclosing fair value to be useful in meeting the objective and requirements of IFRSs.

The IAASB's task force has been following the developments of the expert advisory panel and believes that the draft document, while aimed at preparers of financial statements, will also be useful to auditors as they evaluate fair values developed by management. Areas within the document that may be most relevant include:

- Active versus inactive markets;
- Evaluating available market information;
- Information from brokers and pricing services, including broker quotes;

42 ISA 570, "Going Concern," paragraphs 2 and 11.

43 ISA 570, paragraph 3.

44 Recommendations III.4, III.5, and III.6 of the Report of the FSF.

45 "IASB Expert Advisory Panel: Measuring and disclosing the fair value of financial instruments in markets that are no longer active," draft document issued 16 September 2008, and available at **http://www.iasb.org/Current+Projects/IASB+Projects/Fair+Value+Measurement/Fair+value+of+financial+instruments+in+markets+that+are+no+longer+active.htm**.

- Using models;
- Changes in models and assumptions over time; and
- Enhanced disclosures about financial instruments of particular interest to users.

A recent update on a range of the IASB's projects that respond to the recommendations of the FSF can also be found on the IASB's website.[46]

Recent Revisions to Extant Standards on Auditing Accounting Estimates and Fair Value Measurements and Disclosures—ISA 540 (Revised and Redrafted)[47]

In conjunction with its Clarity project,[48] the IAASB revised a number of its standards including ISA 540, "Audit of Accounting Estimates" (ISA 540). The similarity in the audit approaches to estimates and fair value measurement led to a decision to combine ISA 540 with ISA 545, "Auditing Fair Value Measurements and Disclosures" (ISA 545), thereby revising both standards. The IAASB believes that the combination enhances the distinction between estimates involving fair value measurement and other types of estimates because it draws upon the similarities between the two while contrasting their subtle differences. The revised ISA, ISA 540 (Revised and Redrafted), places more emphasis on areas of higher risk, accounting judgment, and possible bias, thereby assisting the auditor to form appropriate conclusions about the reasonableness of estimates in the context of an entity's financial reporting framework. These are also areas of particular importance in the context of fair values.

The revised ISA also includes expanded guidance on auditing fair value accounting estimates as compared with extant ISA 545, including audit considerations relating to the proper application of the requirements of the financial reporting framework relevant to such estimates[49] and the use of models in valuations.[50]

ISA 540 (Revised and Redrafted) highlights matters such as the auditor's evaluation of the effect of estimation uncertainty on risk assessments, management's methods for making estimates, the reasonableness of assumptions used by management, and the adequacy of disclosures. Such matters are relevant to estimates in general, but are also particularly important in the context of fair values.

ISA 540 (Revised and Redrafted) will be effective for audits of financial periods commencing on or after December 15, 2009, the date when all the standards redrafted under the IAASB's Clarity project become effective.[51] However, 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, it includes guidance that is likely to be useful to auditors planning their 2008 and 2009 engagements and, as such, auditors may wish to consider this new material, available at **http://www.ifac.org/Members/DownLoads/ISA_540_Revised_and_Redrafted.pdf**.

This may particularly be the case, for example, when auditors are faced with circumstances in which the financial instruments the entity has invested in have relatively high estimation uncertainty. These may include fair value accounting estimates for complex financial instruments in general, derivative financial instruments not publicly traded, and fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.

Way Forward

The task force and staff will consider the need for additional information or guidance concerning auditing fair value. Any further work will likely involve coordina-

46 **http://www.iasb.org/News/Press+Releases/IASB+provides+update+on+response+to+credit+crisis.htm**.

47 ISA 540 (Revised and Redrafted), "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures," effective for audits of financial statements for periods beginning on or after December 15, 2009.

48 The aim of the Clarity project is to improve the clarity of IAASB standards, so as to make them more readable and to avoid any possible ambiguity as to what they require and what is guidance, thereby improving the consistency with which they are implemented.

49 ISA 540 (Revised and Redrafted), paragraphs A13-A15 and A120-A121.

50 ISA 540 (Revised and Redrafted), paragraphs A74-A76.

51 ISA 545 will be withdrawn when ISA 540 (Revised and Redrafted) becomes effective, as a result of the combination of the extant standards.

tion with others, including IFAC member bodies, firms, regulators, audit oversight bodies and national auditing standard setters. Some proposed actions, in particular the development of any new practice statements, would involve a formal project proposal to be approved by the IAASB and, as such, are longer-term initiatives subject to the IAASB's due process. For more information on the task force's work to date and the IAASB's discussions, please visit **http://www.ifac.org/IAASB/ProjectHistory.php?ProjID=0080.**

About the IAASB

The objective of the IAASB, an independent standard-setting board within the International Federation of Accountants, is to serve the public interest by setting high quality auditing and assurance standards and by facilitating the convergence of international and national standards, thereby enhancing the quality and uniformity of practice throughout the world and strengthening public confidence in the global auditing and assurance profession. The Public Interest Oversight Board oversees the activities of the IAASB and, as one element of that oversight, establishes the criteria for its due process and working procedures.

For more information about the IAASB, visit its home page at www.iaasb.org.

Key Contacts

Jim Sylph, Executive Director, Professional Standards (**jimsylph@ifac.org**)

Kathleen Kerrigan, Technical Manager, IAASB (**kathleenkerrigan@ifac.org**)

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International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org email: pr@ifac.org