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PCAOB Issues Staff Audit Practice Alert on Fair Value Determinations and OTTI

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On April 21, 2009, the Public Company Accounting Oversight Board ("PCAOB") issued a Staff Audit Practice Alert (the "Alert")[1] to inform auditors about the potential implications of three recently issued Financial Accounting Standards Board Staff Positions (the "FSPs"):

- FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ("FSP FAS 157-4");
- FSP FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ("FSP FAS 115-2"); and
- FSP FAS 107-1 and APB 28-1, *Interim Disclosures about Fair Value of Financial Instruments* ("FSP FAS 107-1").

FSP FAS 157-4 provides additional guidance for estimating fair value in accordance with FASB Statement 157, *Fair Value Measurements*, when the volume and the level of activity for the asset or liability have significantly decreased. FSP FAS 115-2 revises the other-than-temporary impairment guidance in U.S. GAAP for debt securities. FSP FAS 107-1 requires additional disclosures about the fair value of financial instruments for interim reporting periods, as well as in annual financial statements.

The Alert highlights certain aspects of the FSPs that could impact:

- auditors' reviews of interim financial information;
- annual audits of financial statements;
- auditors' review of disclosures; and
- auditors' reporting obligations to audit committees.

Unlike accounting standards set by the Financial Accounting Standards Board, PCAOB alerts are not binding interpretations of U.S. GAAP; however, the Alert provides useful guidance on the preparation, review, and auditing of financial statements and disclosures for auditors, as well as for management and audit committees of public companies.

Reviews of Interim Financial Information

The Alert notes that one of the main objectives of a review is for auditors to determine whether the financial statements require material modifications in order to conform with GAAP, particularly in light of any recent changes to accounting standards. In conducting a review, auditors will perform analytical procedures and interview relevant members of the company's accounting and financial teams. The Alert recommends that auditors include, as part of their reviews, inquiries with management regarding the proper implementation of the new FSPs, if appropriate.

The Alert also makes auditors aware that implementation of the new FSPs may present matters that are required by AU sec. 380, *Communication with Audit Committees*, to be communicated to the company's audit committee. As identified in the Alert, these matters include:

- changes in a significant accounting policy affecting the interim financial information;
- changes in accounting estimates and management's judgments about such estimates;
- changes in the processes used by management to formulate sensitive accounting estimates; and
- the auditor's judgment about the quality of the company's accounting policies.

Audits of Financial Statements

With respect to annual audits of financial statements, the Alert highlights several areas impacted by the new FSPs. As a result of the additional guidance on fair value determinations provided under FSP FAS 157-4, auditors should understand the potential impact on the company's processes for making fair value determinations, the related disclosures regarding such processes, and the company's relevant controls. Based on the level of risk of a material misstatement the auditor attributes to a company's fair value processes, the auditor may conduct tests of the company's fair value measurements, which may include testing key assumptions, valuation models, and the company's underlying data; developing independent fair value assessments for comparative purposes; and reviewing subsequent events and transactions.

Auditors are also cautioned to carefully evaluate the other-than-temporary impairment conclusions made by companies to ensure compliance with FSP FAS 115-2. Auditors will need to gather sufficient evidence to attest to the amount of any impairment and the reasonableness of a company's determination that a portion of such impairment is attributable to credit loss versus other factors. As with a review of interim financials discussed above, implementation of the new FSPs, and in particular FSP FAS 115-2, may result in a material change in accounting policy or other matters set forth in AU sec. 380 that the auditor would be required to communicate to the audit committee.

Disclosures

The Alert highlights a few of the additional disclosure burdens imposed on companies under the new FSPs, including:

- The requirement under FSP FAS 157-4 that a company disclose changes to processes or inputs in connection with fair value determinations; and
- The requirement under FSP FAS 115-2 that a company provide sufficient disclosure regarding the calculation of other-than-temporary impairment and the reasons why an other-than-temporary impairment was not recognized in earnings.

The Alert advises auditors to review these disclosures for compliance with the new FSPs and consistency with the accompanying financial statements.

Auditor Reporting Considerations

The Alert also cautions auditors to consider whether the adoption and implementation of the FSPs will result in a change in accounting principles that materially affects the comparability of the company's financial statements from period to period. Such a change in accounting principles must be noted in the auditor's report accompanying the financial statements.

Recommendations

In addition to the considerations companies must give to the implementation of the new FSPs, public company executives, management, and audit committees must be prepared for additional scrutiny by their auditors, as highlighted in the Alert. As indicated by the recommendations of the Alert, companies can expect their auditors to conduct additional inquiries and testing on those areas impacted by the new FSPs. Company management and the audit committee should bear this in mind when implementing the FSPs, preparing financial statements, and drafting disclosures related to fair value determinations and other-than-temporary impairment, and should be prepared to discuss proper implementation of the FSPs with their auditor during both reviews and annual audits.

Footnotes

[1] Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (April 21, 2009).