

new york state society | *of*

NYSSCPA

certified | *public accountants*

530 fifth avenue, new york, ny 10036-5101

www.nysscpa.org

September 4, 2002

Ms. Gretchen Fischbach
American Institute of Certified Public Accountants
1211 Avenue of the Americas
New York, NY 10036-8775

gfischbach@aicpa.org

Dear Ms. Fischbach:

The New York State Society of Certified Public Accountants, the nation's oldest state accounting association, represents approximately 30,000 CPAs whose audit and attest engagements are affected by the AICPA Auditing Standards Board's (ASB) interpretations and rulings. NYSSCPA thanks ASB for the opportunity to comment on its Exposure Draft on the **Proposed Statement on Auditing Standards, *Auditing Fair Value Measurements and Disclosures***.

The NYSSCPA Auditing Standards and Procedures Committee drafted the comments, which are submitted on the Excel spreadsheet circulated by the ASB. If the ASB would like additional discussion with the committee, please contact Auditing Standards and Procedures Committee Chair Margaret Wood at (212) 338-0748, or NYSSCPA Staff Robert H. Colson at (212) 719-8350.

Sincerely,

Jo Ann Golden
President

Attachment

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**NEW YORK STATE SOCIETY OF
CERTIFIED PUBLIC ACCOUNTANTS**

COMMENTS ON

EXPOSURE DRAFT:

PROPOSED STATEMENT ON AUDITING STANDARDS

Auditing Fair Value Measurements and Disclosures

Principal Drafters

**Robert N. Waxman
Margaret A. Wood**

August 22, 2002

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**NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS
AUDITING STANDARDS AND PROCEDURES COMMITTEE**

COMMENTS ON

**PROPOSED STATEMENT ON AUDITING STANDARDS: Auditing
Fair Value Measurements and Disclosures**

August 22, 2002

General Comments

The proposed auditing standard provides much need organization of the audit process for fair values. The proposed standard does not break much new ground, however, and it does not answer many of the urgent questions about appropriate valuation methods and models, sufficiency of audit evidence, procedures for testing the use of valuation models and methods, and measurement and evaluation of reasonable assurance.

The ASB should consider whether it would be more appropriate to modify SAS 57, *Auditing Accounting Estimates*, rather than issuing a new SAS on fair values. Auditing fair values becomes complex when estimates of fair value are used rather than market prices. Extending SAS 57 to encompass the audits of estimates used for fair value would allow the publication of specific guidance in audit guides when the estimates become too complex or unique for the application of general principles.

Wherever the proposed standard is handled within GAAS, it should include cross-references to the authoritative auditing literature that deals with

- “Other than temporary declines.”
- Audit and disclosure requirements when fair values are determined “in good faith” by management or the board.
- Unreasonable or inadequate valuation procedures.
- Insufficient support for a model, method, or estimate.

The procedures found in Practice Alert No. 2002-2, *Use of Specialists*, that are not now in SAS 73 should be incorporated in the proposed for circumstances where the auditor relies on the work of a specialist for a material percentage of the amounts in the financial statements.

Specific Comments

Paragraph No. or Other Reference	Comment
Paragraph No. 1	Sentences one and two: One of the avowed purposes of this SAS is to "establish standards and provide guidance" relating to the <u>presentation</u> of assets, liabilities, and specific components of equity. The only guidance pertaining to presentation (1) ensures that the presentation of fair value measurements is in accordance with GAAP (paragraph 4), and (2) determines the impact of management's intentions on the presentation (paragraph 18). Missing from this proposed SAS are auditing standards and guidance applicable to the <u>presentation</u> of fair value measurements. Further, because fair value measurements may also enter into the initial recognition of expenses and income (e.g., through the exchange of a nonmonetary asset for services or products), sentence two should be expanded to cover income statement transactions.
Paragraph No. 2	The audit considerations relating to the presentation of fair value measurement should be addressed in this paragraph, as in paragraph 1.
Paragraph No. 3	The general standards require that auditors "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement" (AU 110.02, 230.10, 316.01, etc.). Further, AU 431 covers the auditor's responsibilities for the adequacy of disclosures in financial statements. There is no general or other auditing standard that specifically requires a particular measurement or disclosure conform with GAAP. In short, the general standards already cover the point in this paragraph, rendering it unnecessary. This paragraph should also address presentation considerations, as in paragraph 1, which addresses measurement, presentation, and disclosure.
Paragraph No. 4	Management does not determine fair values using an "accounting process" as such. Rather, fair value is determined by the most appropriate valuation method, such as discounted cash flow, comparable analysis, and option models. The "accounting process" merely records the measured fair value in the financial statements.
Paragraph No. 5	"Many measurements based on estimates" These introductory words would be better expressed as, "Many measurements are based on estimates that are in turn based on assumptions...." See AU 332. Such wording will then link with the third sentence concerning the "auditor's consideration of such assumptions"

Paragraph No. 6	No comments.
Paragraph No. 7	The last sentence should include a requirement that, in addition to creating a plan, management must have the ability to carry out such plans. An important consideration in auditing fair value is mentioned in the third sentence, but this proposed SAS provides neither the standards nor the guidance for how the auditor obtains sufficient competent audit evidence about the current economic environment, the operating situation, or the type and extent of economic and operating documentation required in an audit. Although references to various definitions permeate paragraph, the sole example (contained in FAS 141 and FAS 142) does not begin to cover all the possibilities. The final SAS should identify in an appendix other definitions of fair value used in GAAP.
Paragraph No. 8	No comments.
Paragraph No. 9	No comments.
Paragraph No. 10	The last sentence should be extended and strengthened. This sentence along with paragraph 5 says that management must consider both future and current conditions, transactions, and events to determine fair value. Paragraphs 42 and 43, "Reviewing Subsequent Events," clarifies that economic events occurring after the balance sheet date should not be considered in determining fair value. Paragraph 27, item c, requires management to use information "reasonably available at the time." This SAS should provide additional guidance and examples about (1) the use of "future events or their outcome" in determining fair values and (2) how the auditor verifies such predictions about the future.
Paragraph No. 11	After "determination of the entity's fair value measurements" add the phrase, "accounting for the fair valued transactions"
Paragraph No. 12	After "determining fair value measurements" add, "accounting for the fair valued transactions".... The introduction should eliminate the words "for example." Tenth bullet: In addition to the integrity of change controls and security procedures, an important element (missing from this list of examples) is the auditor's obtaining a complete understanding of the valuation model itself. Delete the word "significant" from the seventh bullet because it ordinarily may not be feasible to distinguish levels of significance when it comes to assumptions and their permutations. If this wording is maintained, then the standard should guide the auditor in how to evaluate assumptions in the context of their effect on other assumptions so that significance may be determined with some level of assurance.
Paragraph No. 13	No comments.

Paragraph No. 14	No comments.
Paragraph No. 15	Fair value measurements should be differentiated from accounting for fair values and the word "accounting" should be inserted after "measurements." In addition, fair values may initially be recorded as an expense or revenue and the "accounting for assets and liabilities" should be expanded to cover these transactions. To make the guidance in this proposed SAS useful, examples of the footnotes that explain the significant uncertainties should be illustrated (without using boiler plate language such as "due to inherent limitations, and subjectivity involved in, of determining fair values, the amounts recorded are managements estimates, different assumptions would result in different results, etc.").
Paragraph No. 16	This paragraph mentions "nature of the business" and separately "nature of the entity and its operations." This distinction should be clarified and emphasized. The first three sentences imply that audit evidence depends in part on the nature of the business and this relationship is (in part) true because different assumptions may result in different conclusions. The logic in these sentences should be clarified and expanded. Saying different assumptions may result in different conclusions is not very insightful.
Paragraph No. 17	No comments.
Paragraph No. 18	Second bullet: The phrase "and such other items" should either be eliminated or expanded upon. This phrase translates into "and so forth" and does not add any guidance.
Paragraph No. 19	The evaluation of the appropriateness of the valuation method is essential to the audit and the most troubling because of the level of subjectivity that may be involved. This proposed SAS lacks the guidance auditors need to make the necessary evaluations of appropriateness.
Paragraph No. 20	Determining whether consistency is appropriate complicates the auditor's dilemma because possible or future changes in the environment or circumstances must be carefully tracked, understood, and evaluated. This requirement would need a full understanding of micro- and macro-economics, local and world economic trends, and deep industry knowledge (past, present and future). Amplification as to how this would be accomplished should be added to this SAS by means of examples of trigger events.
Paragraph No. 21	SAS 73 on the use of specialists in an audit does not require that the specialist assess either management's intent and ability to carry out a course of action (see paragraph 18) or the effect on the valuation of changes in the environment or circumstances (see paragraph 20). The requirements of the proposed SAS imply that SAS 73 is deficient in these regards, and that following SAS 73 may not be sufficient for the specialist to arrive at a "fair value"

appropriate to the entity.

- Paragraph No. 22 We would add to the example that the specialist must also be familiar with management's intention for the item being valued in addition to the measurement principles specified in GAAP. Management has the responsibility to communicate to the specialist their plans and intentions.
- Paragraph No. 23 The summary here is inadequate; quote all of paragraph 12 of AU 336.
- Paragraph No. 24 No comments.
- Paragraph No. 25 This SAS should provide guidance or cross-reference to the appropriate standards covering what the auditor must do when there are significant amounts that are "highly subjective," and as such, are not "auditable," i.e., there is not a basis to determine reasonableness. Further, is there a "comparative transaction model," or should it be a "comparative transaction approach?"
- Paragraph No. 26 The first bullet is apt, but the valuation of restricted securities continues to be a difficult area. Is it enough to say there will be a misstatement if the quoted market is used? More and much better guidance is needed.
- Paragraph No. 27 These tests present the challenges of knowing what is "reasonable," determining whether the model used is "appropriate," and that management has used all the relevant information available. To move this proposed SAS from the general to the specific, and to be useful, it must discuss how these objectives are accomplished.
- Paragraph No. 28 This proposed SAS should provide the auditor with guidance (by example) about the specific economic indicators the auditor should track and the trigger events that would affect fair values, to ensure that changes in underlying economic circumstances are properly reflected in the determination of fair values.
- Paragraph No. 29 No comments.
- Paragraph No. 30 The footnote cites in full SAS 73; it should also be cited (in full) in paragraph 21.
- Paragraph No. 31 No comments.
- Paragraph No. 32 The distinction between plans that are within the "entity's capacity" versus "management's ability" to carry out their intentions is discussed elsewhere in the SAS. If this distinction is intentional, it should be more thorough.

Paragraph No. 33	This paragraph, along with paragraph 25, points out the inherent problem with auditing fair values; that is, the overwhelming subjectivity of the entire process, including assumptions based on other assumptions, which may produce nonverifiable results. A minor change in one assumption cascades through all the calculations resulting in an amount that appears reasonable, but is not necessarily reproducible by others.
Paragraph No. 34	This SAS should provide sufficient guidance about how to test for completeness; that is, how is an auditor satisfied that all significant assumptions have been identified.
Paragraph No. 35	"Sensitivity analysis" or "value at risk" are tools to identify significant assumptions. In this paragraph, the auditor is asked to consider using "techniques" to identify particularly sensitive assumptions. This SAS should furnish guidance about how and when to use sensitivity analysis, especially in view of the discussion with the audit committee mentioned in paragraph 52 about assumptions that are "particularly sensitive."
Paragraph No. 36	No comments.
Paragraph No. 37	No comments.
Paragraph No. 38	No comments.
Paragraph No. 39	Cross-reference to AU 332.40 for an expanded discussion of the appropriateness of the model.
Paragraph No. 40	No comments.
Paragraph No. 41	No comments.
Paragraph No. 42	No comments.
Paragraph No. 43	No comments.
Paragraph No. 44	It is important to disclose how much of the balance sheet consists of items carried at fair value. For example, a disclosure that says "62% of the total assets are carried at fair value" would signal to users that the majority of the entity's assets are at carrying values that may (or may not) be highly subjective (depending on the mix of assets, the type and nature of the assumptions, and the model used).
Paragraph No. 45	No comments.

Paragraph No. 46	Augment this paragraph with an example of the disclosure that would satisfy SOP 94-6. While SOP 94-6 mentions the use of estimates of fair value, it does not provide adequate guidance, and, therefore, this proposed SAS should be expanded to require more explicit disclosures concerning the extent to which fair values are used in the financial statements; e.g., the percentage of total assets and liabilities carried at fair value. This disclosure would then conform to paragraph 52 guidance when the auditor considers discussing with the audit committee the relative materiality of the items measured at fair value to the financial statements as a whole.
Paragraph No. 47	No comments.
Paragraph No. 48	No comments.
Paragraph No. 49	No comments.
Paragraph No. 50	Illustrative management representation language concerning the matters covered in the proposed SAS would provide auditors needed guidance.
Paragraph No. 51	No comments.
Paragraph No. 52	This audit step should also be included in AU 342 since it applies to all estimates and not only to those involved in the determination of fair values. Without the use of sensitivity analysis, or value at risk, there ordinarily would be no way to differentiate the "sensitivity" of estimates. Therefore, the word "particularly" should be used only when such analysis is specifically performed, otherwise it cannot (and should not) be discussed with the audit committee.
Paragraph No. 53	No comments.
Other Comments	Overall, the proposed SAS provides much needed organization of the audit process in regard to fair values; however, there does not appear to be much new ground broken. Auditors are particularly interested in useful guidance on the appropriate valuation methods and models, sufficiency of audit evidence, how to measure and evaluate levels of reasonable assurance, and other procedures, but this SAS does not answer this urgent need. It is not enough to say, "make sure the entity is using an appropriate model" (the sense of paragraph 27). Much of the standard is already covered in the existing GAAS literature and there is a view that SAS 57, "Auditing Accounting Estimates" is the appropriate section of GAAS that should be modified to deal with the audit of fair values. Where estimates and the auditing of such estimates are very complex or unique,

specific guidance would then be issued in the form of audit guides.

This SAS should encompass (or cross-reference to) the auditing of "other than temporary declines," and the auditing and disclosure requirements when fair values are determined in "good faith" by management or the board of trustees.

There should be cross-references to the literature that deals with those situations where the valuation procedures are unreasonable or inadequate, and when there is insufficient support for the fair values used.

Where the work of a specialist is relied upon for a material percentage of the amounts contained in the financial statements, this SAS should encompass those procedures found in Practice Alert No. 2002-2, "Use of Specialists" that are not now found in SAS 73.