

BUSINESS VALUATION REVIEW

WILL YOUR FAIR VALUE MEASUREMENTS FOR GAAP PROVIDE SATISFACTORY EVIDENCE FOR GAAS?

by

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Generally-accepted auditing standards (“GAAS”) promulgated by the American Institute of Certified Public Accountants (“AICPA”) in the United States and the Canadian Institute of Chartered Accountants (“CICA”) in Canada require that the independent auditor perform a number of specific procedures in testing fair value measurements and disclosures (“FVM&D”) for financial statement reporting purposes. In Canada, the general framework for the audit of FVM&D is effective for fiscal years beginning on or after June 30, 2004 and, in the U.S., for fiscal periods that commenced on or after June 15, 2003.

This article, which should be read in conjunction with the *full text of the standard Independent Auditor’s Report*, identifies the types of audit procedures that the business valuator must be aware of in light of the standards that Chartered Accountants and Certified Public Accountants must adhere to in their professional assessment, as independent auditors, of whether the fair values of an entity’s assets are measured and disclosed in accordance with generally-accepted accounting principles (“GAAP”). The degree to which the business valuator’s “fair value” opinion will be subject to rigid scrutiny by the client’s auditor (or by the auditor’s in-house fair value measurement specialist) will be similar to that in litigation-related engagements where the opposing expert will challenge the integrity of the valuation, often criticizing the underlying facts and assumptions relied upon, methodology, procedures and judgment calls.

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As there are myriad analyses and articles published with respect to FVM&D in a host of accounting and valuation journals, accounting practice aids, as well as numerous professional conference presentations, this commentary will be confined only to GAAS and will not delve into GAAP issues. For background purposes, however, it may be helpful to make reference to the relevant *accounting* standards promulgated by the respective U.S. and Canadian professional bodies (the Financial Accounting Standards Board (“FASB”) and the CICA, respectively) regarding FVM&D:

<u>Subject Matter</u>	<u>U.S.A.¹</u>	<u>Canada</u>
Allocation of Purchase Price in Business Combinations	FASB 141	CICA 1581
Annual Impairment Test — goodwill and other intangible assets	FASB 142	CICA 3062
Financial reporting in reorganizations under bankruptcy laws: “fresh start” accounting (Chapter 11 in the U.S. and <i>Companies’ Creditors Arrangement Act</i> in Canada)	SOP 90-7	CICA 1625
Impairment or disposal of long-lived assets; Using Cash Flow Information and Present Value in Accounting Measurements	FASB 144	CICA 3063

(On June 23, 2004, the FASB issued a comprehensive Exposure Draft of a Proposed Statement of Financial Accounting Standards, entitled “Fair Value Measurements”, with a comment deadline of September 7, 2004.)

Before turning to the auditing requirements, there are three points that should be mentioned with respect to fair value:

(1) Accounting measurements that use cash flow information, thereby raising issues of present value, are also found in FASB Technical Bulletins, AICPA Statements of Positions and Audit and Accounting Guidelines, and in consensus decisions of the FASB’s Emerging Issues Task Force. The FASB has also issued Statement of Financial Accounting Concepts (“CON”) No. 7, “Using Cash Flow Information and Present Value in Accounting Measurements” (non-binding). FASB’s International Accounting Board and the Canadian Accounting Standards Board are currently addressing measurement issues in a joint research project.

1. The basis is “estimated fair values”² in the U.S. and “estimated or appraised values”³ in Canada;
2. Liabilities, and not only assets, are subject to FVM&D; and
3. GAAP establishes a “hierarchy” for fair value measurements, preferring quoted market prices in active markets, if available, as being the best evidence of fair value.⁴

The hierarchy for fair value measurement establishes three “levels”:

- **Level 1 Estimates**

Quoted prices⁵ for *identical* assets or liabilities in the most advantageous, active market to which an entity has immediate access, considering the current condition and location of the asset valued (market approach).

- **Level 2 Estimates**

Quoted prices⁶ for *similar* assets or liabilities in the most advantageous, active market to which an entity has reasonable access, adjusted as appropriate for qualitative and quantitative differences, considering the current condition and location of the asset being valued (market approach).

- **Level 3 Estimates**

Results of valuation methods generally consistent with those used by **market participants** in pricing the types of assets or liabilities being measured. In making a Level 3 Estimate, more than one valuation method should be applied when the information is available, including the consideration of market and transactional data.

(2) FASB 141.37(e).

(3) CICA 1581.43(e).

(4) FASB 142.23 and CICA 1581, Appendix A. See, also, FASB, “Project Updates — Fair Value Measurements”, April 21, 2004.

(5) Quoted market prices in active markets are the best evidence of fair value and shall be used as the basis for the measurements, if available (FASB 142.23 and CICA 1581, Appendix A). See, also, FASB, “Project Updates — Fair Value Measurements”, April 21, 2004.

(6) *Id.*

The testing by the auditor of Level 2 and 3 Estimates is outlined later in this article.

Fair Value Audit Requirements — General

FVM&D audit requirements under GAAS are promulgated by the Auditing Standards Board of the AICPA in *Statement on Auditing Standards* No. 101 (“SAS No. 101”) (AICPA, Professional Standards, Vol. 1 AU Section 328) and by the CICA in *Handbook* Section 5306 (“CICA 5306”), entitled “Auditing Fair Value Measurements and Disclosures”, which establish standards and provide guidance on auditing FVM&D for financial statement purposes.⁷ It is important to note that there are closely-related auditing standards in SAS No. 73 and AU 336⁸ in the U.S. and CICA *Handbook* Section 5049 in Canada; these address the use of specialists, including business valuers, in audit assurance engagements.

SAS No. 101 and CICA 5306 address considerations under GAAS relating to the measurement, presentation and disclosure of material assets, liabilities, and specific components of equity presented or disclosed at *fair value* in financial statements. (In Canada, fair value is defined as “the amount of the consideration that would be agreed upon in an arm’s length transaction between knowledgeable, willing parties who are under no compulsion to act”. In the U.S., the definition is revised to refer to “the current price at which an asset or liability could be exchanged in a hypothetical transaction between knowledgeable, unrelated parties”.)

The audit requirements apply even when management has retained an accredited valuation specialist, such as an ASA, to prepare the fair value estimate.

SAS No. 101 and CICA 5306 state that *management* is responsible for making the fair value measurements and disclosures included in the financial statements. As part of fulfilling its responsibility, *management* must establish an accounting and financial reporting process for determining the FVM&D, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation, and insure that the presentation and disclosure of the fair value measurements are in accordance with GAAP.

As discussed below, if management had retained a business valuator, GAAS require the auditor to consider the valuator’s expertise and experience and evaluate whether the data on which the estimate of fair value is based (including the data used by the valuator) are accurate, complete

(7) SAS No. 101 is the first auditing standard the Auditing Standards Board in the U.S. developed in conjunction with the International Auditing and Assurance Board of the International Federation of Accountants.

(8) AICPA, *Professional Standards*, Vol. 1, AU Section 336, “Using the Work of a Specialist”. See, also, AICPA Practice Alert No. 2002-02 (“Use of Specialists”).

and relevant, and whether such fair value has been properly determined using these data as well as management's assumptions. In this regard, the auditor might verify the source of the data, the mathematical calculations, and review the relevant information for internal consistency, e.g., whether this information is consistent with both the intent and ability of management to carry out specific courses of action (when intent is relevant to the use of fair value measurements). This point is particularly relevant when "significant assumptions" made by management can materially impact fair value. The auditing issues, and how they affect business valuations opining on "fair value", are commented on below

Audit Procedures for FVM&D — General

The audit procedures applied under GAAS in order for the auditor to evaluate whether the FVM&D are in accordance with GAAP (FASB 141 and 142, SOP 97-3, and CICA 1581, 1625, and 3062, as the case may be) may be outlined as follows:

- Gaining an understanding of the entity's process, including relevant controls and the role that information technology has in the process, for determining FVM&D sufficient to develop an effective audit approach.
- Considering the extent to which management had retained valuation specialists or others in determining FVM&D.
- Assessing inherent and control risk related to FVM&D to determine the nature, timing, and extent of audit procedures.
- Evaluating whether the FVM&D in the financial statements are in accordance with GAAP.
- Considering significant management assumptions used in determining fair value.
- Obtaining evidence, usually through enquiries (responses to which would be corroborated), as to both management's intent and ability to carry out specific courses of action relative to the significant assumptions when intent is relevant to FVM&D under GAAP.
- Evaluating by (among other things) discussing with management its reasons for the selection of the valuation method adopted, and whether such method is appropriate under GAAP when alternative methods for measuring fair value are available, or when the valuation method is not prescribed.

- Evaluating whether the entity’s method for measuring fair values is applied in a consistent manner.
- Determining the need to use the work and findings of a specialist, e.g., a business valuator.

Testing the Entity’s FVM&D

The independent auditor will perform the following mandatory procedures, among others:

- Testing the entity’s FVM&D by reviewing management’s “significant assumptions”, the valuation model, and underlying documentation and information.
- Evaluating whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for FVM&D.
- Testing the data that were used to develop fair value measurements and evaluating whether they have been properly determined from these data and from management’s assumptions, and whether management used available market information to develop the assumptions.
- Developing independent estimates of fair value to corroborate the appropriateness of the fair value measurement, using sensitivity analysis, if necessary.
- Considering the effect of subsequent events on FVM&D, in which case the auditor will comply with the separate *auditing* standards specifically relating to Subsequent Events. Fair value (like fair market value) is measured as of a specific point in time, i.e., valuation date (e.g., the fiscal year-end date for balance sheet reporting). For example, GAAS states that:

“.41 Events and transactions that occur after the balance-sheet date but before the completion of fieldwork (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. 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.

“.42 Some subsequent events or transactions may reflect changes in circumstances occurring after the balance-sheet data and thus do not constitute competent 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 substantiate a fair value measurement, the auditor considers only those events or transactions that reflect circumstances existing at the balance-sheet date.”⁹

- Evaluating the sufficiency and appropriateness of the audit evidence¹⁰ obtained, and the consistency of such evidence with other evidence gathered during the audit.
- Considering whether any matters should be communicated with the audit committee.

Auditing Management’s Significant Assumptions

What is particularly relevant for business valuers in this regard are the procedures and tests that are applied by the *auditor* in evaluating whether the “significant assumptions” used by management to estimate fair value, taken individually and as a whole, provide a reasonable basis for inclusion of the fair values in the entity’s financial statements. Surely, if these tests must be applied by the *auditor*, they should presumably have already been applied by the *business valuator* in arriving at fair value. Assumptions go to the heart of projections.

GAAS requires the auditor to evaluate whether the assumptions made by management were reasonable and reflect, or are not inconsistent with, market information (such as that used by market participants).

The auditor may also test the reliability of management’s fair value measurement processes by comparing results obtained in the current period with those determined in a prior period, taking into account whether the variances might have resulted from changes in market or economic conditions. For example:

“Specific assumptions will vary with the characteristics of the asset or liability being valued and the valuation method used (for example, market or an income-based approach). For example, when discounted cash flows (an income-based approach) are used as the valuation method, there will be assumptions about the level of cash flows, the period of time used in the analysis, and the discount rate.

...

“Identifying those assumptions that appear to be significant to the fair value measurement requires the exercise of judgment by management. The auditor

(9) AICPA, AU Section 328, *Auditing Fair Value Measurements and Disclosures*.

(10) “Audit evidence” is defined as “all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based”.

focuses attention on significant assumptions. 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.

The auditor considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value. When applicable, the auditor encourages management to use such techniques as sensitivity analysis to help identify particularly sensitive assumptions. In the absence of such management analysis, the auditor considers whether to employ such techniques.¹¹

In evaluating whether significant assumptions used by management in measuring fair value (including assumptions relied upon by management based on the work of a specialist) provide a reasonable basis for financial statement inclusion, the auditor will review the assumptions, individually and taken as a whole, to determine whether they are realistic and consistent with:

- The general economic environment and the entity's economic circumstances;
- Existing market information;
- The entity's plans, including management's expectations of the outcome of specific objectives and strategies;
- Assumptions that were made in prior periods, if appropriate;
- Past experience of, or previous conditions experienced by, the entity to extent currently applicable;
- Assumptions used by management in accounting estimates for financial statement accounts other than those relating to FVM&D;
- Any risk associated with cash flows, including potential variability thereof and related effect on the discount rate.

As noted earlier, the auditor must consider whether the assumptions reflecting both management's intent and ability to carry out specific courses of action are consistent with the entity's actual plans and past experience.

(11) AU Section 328 and CICA 5306.

The auditor will review the valuation model to see whether it is appropriate and the underlying assumptions are reasonable.

The auditor will consider the effect of subsequent events on the FVM&D in the financial statements, applying the relevant auditing standards *vis-à-vis* subsequent events. While hindsight is clearly inadmissible in business valuation, the valuator should consider retrospective evidence in testing the fair value measurement conclusions — just as the auditor would be required to, notwithstanding that the fair value would be expressed as of a point in time.

Testing “Levels 2 and 3” Estimates

Levels 2 and 3 of the hierarchy referred to earlier, i.e., where there are no quoted prices in an active market, contemplates estimating fair value based on an alternative approach, such as the discounted cash flow method or the merger and acquisition method. In the case of the DCF method, it is recognized that there would be greater uncertainty:

“ ... For example, in the absence of quoted prices in an active market, generally accepted accounting principles permit an estimate of fair value based on an alternative basis such as a discounted cash flow method or a comparative transaction model. 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:

- (a) the length of the forecast period;
- (b) the number of significant and complex assumptions associated with the process;
- (c) a higher degree of subjectivity associated with the assumptions and factors used in the process;
- (d) a higher degree of uncertainty associated with the future occurrence or outcome of events underlying the assumptions used; or
- (e) lack of objective data when highly subjective factors are used.¹²

(12) CICA 5306.36.

Using the Work of a Business Valuator

In fair value measurement, the business valuation specialist may have been (a) engaged by the auditor, (b) engaged by the client (management), (c) an employee of the client, or (d) a member of the auditing firm. (In the first case, the auditor would have considered whether to engage the specialist and use such work as evidential matter in performing substantive tests to evaluate material financial statement assertions.¹³)

Apart from considerations as to whether the valuator is a member of the auditing firm or had been engaged by management (and the respective level of assurance that would ensue for audit purposes), GAAS require the independent auditor to consider the following in assessing the reliability and integrity of the fair value calculations:

- The professional qualifications of the valuator, including: certifications, licenses, or other recognition as to competence, e.g., whether valuator possesses an accreditation in valuation issued by a recognized body, such as the American Society of Appraisers (ASA), the Institute of Business Appraisers (IBA), The Canadian Institute of Chartered Business Valuators (CICBV), the AICPA, etc.
- The reputation and standing of the valuator in the eyes of his or her peers and others familiar with his/her capability or performance (publications, speeches, or other external validation).
- The valuator's experience in providing fair value opinions to the enterprise, including whether the valuator has fair value experience in the particular industry or is otherwise knowledgeable of the industry.
- Whether the valuator is familiar with the guidance in the relevant accounting pronouncements (FASB or CICA).
- The valuator's knowledge and understanding of accounting concepts or requirements applicable to the subject matter of his or her engagement and, where applicable, relevant laws and regulations.
- The valuator's experience in the type of assignment, relevant to the fair value measurement.

(13) See, for example, SAS No. 73 (AU sections 336.08-.09); AICPA Practice Aid, *Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and the Pharmaceutical Industries*, 2001; and *Auditing Fair Value Measurements and Disclosures: A Toolkit for Auditors*, AICPA, 2002.

In reviewing the valuator's opinion, the auditor will consider the following:

- Objectives and scope of the valuator's work;
- Valuator's relationship to the client;
- Valuator's methods and assumptions used, including consistency with those used in preceding periods and those used by similar valuers, if known;
- Valuator's compliance with the audit requirements;
- Appropriateness of using the valuator's work for the intended purpose; and
- Form and content of the valuator's findings.¹⁴

Where the *client* retains the services of a business valuator, the auditor might communicate with the valuator to confirm the terms of the latter's engagement and address other relevant matters, such as:

- Auditor's intended use of the valuator's work.
- Identification of data to be supplied by the client to the valuator, so that the auditor is aware of what must be tested for audit purposes.
- Any non-client data that the valuator intends to use.
- Extent of the valuator's access to appropriate records and files.
- Confidentiality of the client's information.
- Documentation or further information required supporting the auditor's procedures and report.

The auditor must, however, carefully ensure that, at all times, he or she will not "influence" valuation methodology, development of capitalization/discount rates, selection of royalty rates, etc. The auditor may not issue an Independent Auditor's Report if the auditor has been involved in the development of the valuation opinion; nor may the auditor perform valuation services (pursuant to *Sarbanes-Oxley Act* of 2002 and, in Canada for example, the *CICA Guide to New Canadian Independence Standards*), etc. There should be no "judgmental" valuation input that might compromise the independence of the auditor and, indeed, that of the valuator.

(14) AICPA Practice Alert No. 2002-02 ("Use of Specialists").

The effect of the valuator's work on the independent auditor's report (SAS No. 73) may be summarized as follows:

- If the auditor determines that the valuator's findings support the related assertions in financial statements, he/she may reasonably conclude that sufficient competent evidential matter has been obtained.
- If the auditor determines that there is a material difference between the valuator's findings and the assertions in financial statements, additional procedures should be applied.
- If, after applying any additional procedures that might be appropriate, the auditor is unable to resolve matter, he/she should obtain the opinion of another valuator, unless it appears to the auditor that the matter cannot be resolved.

Conclusion

Obviously, the foregoing simply "scratches the surface"; perhaps it is the "tip of the iceberg". However, it hopefully underscores the degree to which care and due diligence must be exercised by the business valuator in fair value measurement engagements. In many, if not most, cases, the valuator who is a member of the auditing firm will review the opinion and underlying work performed by the fair value measurement specialist retained by management. In this regard, the auditing firm's valuator (who reports to the audit partner) will be scrutinizing the report with the same critical analysis and intensity when performing a critique of a valuation opinion in financial litigation. It has been this author's experience that, in rendering fair value opinions, his counterpart (business valuator) at the auditing firm will scrutinize the valuation with a fine-tooth comb, "challenging" the various judgmental factors applied (methodology, assumptions, adjustments made, royalty rates used, remaining useful life analyses, contributory asset charges, market data comparability, the underlying data used, and so forth).

The tasks relating to FVM&D are huge and demanding, with the work of management, the business valutors, and the auditors being under unparalleled scrutiny at each level.

In light of the foregoing, the business valuator would be well advised to prepare a convincing, "user-friendly" (i.e., "auditor-friendly") valuation report, supported by a well-documented file, to be used in discussions with — or even to be handed over to — the auditor and his or her fair value measurement consultant. The valuator should be prepared to address — and defend — the numerous issues that will undoubtedly be raised with respect to the fair value opinion, as specifically identified and required by GAAS and, of course, the relevant business valuation practice standards.