Auditing Fair Value
Measurements And Disclosures
Proposed International Standard on Auditing

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# AUDITING FAIR VALUE MEASUREMENTS AND DISCLOSURES

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International Standards on Auditing (ISAs) are to be applied in the audit of financial statements. ISAs are also to be applied, adapted as necessary, to the audit of other information and to related services.

ISAs contain the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material. The basic principles and essential procedures are to be interpreted in the context of the explanatory and other material that provide guidance for their application.

To understand and apply the basic principles and essential procedures together with the related guidance, it is necessary to consider the whole text of the ISA including explanatory and other material contained in the ISA, not just that text which is black lettered.

In exceptional circumstances, an auditor may judge it necessary to depart from an ISA in order to more effectively achieve the object of an audit. When such a situation arises, the auditor should be prepared to justify the departure.

ISAs need only be applied to material matters.

The Public Sector Perspective (PSP) issued by the Public Sector Committee of the International Federation of Accountants is set out at the end of an ISA. Where no PSP is added, the ISA is applicable in all material respects to the public sector.
Introduction

1. The purpose of this International Standard on Auditing (ISA) is to establish standards and provide guidance on auditing fair value measurements and disclosures contained in financial statements. In particular, this ISA addresses audit considerations relating to the valuation, measurement, presentation and disclosure for material assets, liabilities and specific components of equity presented or disclosed at fair value 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. 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 reflecting them in income.

2. While this ISA provides guidance on auditing fair value measurements and disclosures, evidence obtained from other audit procedures also may provide evidence relevant to fair values. For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant evidence about its valuation. The interrelationship of audit procedures and the audit evidence obtained from such interrelated procedures are considered when planning and performing the audit.

3. The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity’s identified financial reporting framework.

4. Management is responsible for the fair value measurements and disclosures included in the financial statements. Certain fair value measurements are based on assumptions about future conditions, transactions or events whose outcome is uncertain and will therefore be subject to change over time. Such assumptions are similar in nature to those required when developing an accounting estimate.

5. ISA 540, “Audit of Accounting Estimates” provides guidance on auditing accounting estimates. This ISA, however, addresses similar considerations as well as others in the specific context of fair value measurements and disclosures in accordance with an identified financial reporting framework.

6. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist. While this ISA provides guidance on auditing fair value measurements and disclosures, it does not address specific types of assets or liabilities, transactions, or industry-specific practices. Appendix 1 to this ISA 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. For example, International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement” defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”
7. Underlying the concept of fair value measurements is a presumption that the entity is a going concern without any intention or need to liquidate, curtail materially the scale of its operations, or undertake a transaction on adverse terms. Therefore, fair value would not be the amount that an entity would receive or pay in a forced transaction, involuntary liquidation, or distress sale. An entity, however, may need to take its current economic or operating situation into account in determining the fair values of its assets and liabilities if prescribed or permitted to do so by its financial reporting framework and such framework may or may not specify how that is done. For example, management’s plan to liquidate an asset on an accelerated basis to meet specific business objectives would be relevant to the determination of the fair value of that asset.

8. The measurement of fair value may be relatively simple for certain assets or liabilities, for example, assets that are bought and sold in active and open markets that provide readily available and reliable information on the prices at which actual exchanges occur. The measurement of fair value for other assets or liabilities may be more complex. A specific asset may not have an active market or may possess such unique characteristics that it becomes necessary for management to estimate its fair value (for example, an investment property or a complex derivative financial instrument). The estimation of fair value may be achieved through the use of a valuation model (for example, a model premised on projections and discounting of future cash flows) or through the assistance of an expert, such as an independent appraiser.

Understanding Internal Control and Assessing Risk

9. The auditor should obtain an understanding of the entity’s process for determining fair value measurements and disclosures sufficient to identify relevant control procedures and to develop an effective audit approach.

10. When obtaining an understanding of the entity’s process for preparing fair value measurements and disclosures, the auditor considers, for example:

   • The internal controls over the systems used to prepare fair value measurements.
   • The expertise and experience of those persons preparing the fair value measurements.
   • The extent to which the entity’s process relies on a service organization to provide fair value measurements. Where an entity uses a service organization, the auditor complies with the requirements of ISA 402, “Audit Considerations Relating to Entities Using Service Organizations.”
   • The documentation prepared by the entity supporting management’s assumptions.
   • The methods used to develop and apply assumptions.

11. After obtaining an understanding of the entity’s process for preparing fair value measurements and disclosures, the auditor should assess inherent and control risk related to the fair value measurements and disclosures in the financial statements.

12. ISA 400, “Risk Assessment and Internal Control,” requires the auditor to obtain an understanding of the control procedures, sufficient to develop the audit plan. In the specific context of this standard, the auditor obtains such an understanding related to the determination of the entity’s fair value measurements and disclosures in order to plan the
nature, timing and extent of the audit procedures. The nature, timing and extent of the audit procedures will depend upon whether the process for determining fair value measurements is relatively simple or complex.

13. ISA 400 discusses the inherent limitations of internal controls. As fair value determinations often involve subjective judgments by management, this may affect the nature of control procedures that are capable of being implemented. The auditor considers the inherent limitations of such controls in assessing control risk.

Assessing the Appropriateness of Fair Value Measurements and Disclosures

14. **The auditor should assess whether the fair value measurements and disclosures in the financial statements are in accordance with the entity’s financial reporting framework.**

15. The assessment of the appropriateness of the entity’s fair value measurements under its financial reporting framework and the evaluation of audit evidence depends, in part, on the auditor’s knowledge of the business. This is particularly true where the asset or liability or the valuation method is highly complex. For example, derivative financial instruments may be highly complex, with a risk of differing interpretations of how to determine fair values resulting in different conclusions. The measurement of the fair value of some items, for example “in-process research and development” or intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations if such considerations are appropriate under the entity’s financial reporting framework.

16. The auditor’s understanding of the requirements of the financial reporting framework and knowledge of the business, together with the results of other audit procedures, are used to assess whether the accounting for assets or liabilities requiring fair value measurements is appropriate, and whether the disclosures about the basis for the fair value measurements and significant uncertainties related thereto are appropriate.

17. Where the method for measuring fair value is specified by the financial reporting framework, for example, the requirement that the fair value of a marketable security be measured using quoted market prices as opposed to using a valuation model, the auditor considers whether the measurement of fair value is consistent with the method prescribed by the financial reporting framework.

18. Some financial reporting frameworks presume that fair value can be measured reliably for assets or liabilities as a prerequisite to either requiring or permitting fair value measurements or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable. When management has determined that it has overcome the presumption that fair value can be reliably determined, the auditor obtains sufficient appropriate audit evidence to support such determination, and whether the item is properly accounted for under the financial reporting framework.

19. **The auditor should assess management’s intent to carry out specific courses of action**
financial reporting framework.

20. In some financial reporting frameworks, management’s intentions with respect to an asset or liability are criteria for determining measurement at fair value, presentation and disclosure requirements, and how changes in fair values are treated within financial statements. In such financial reporting frameworks, the assessment of management’s intent is important in determining the appropriateness of the entity’s use and basis of accounting for fair value. It is the responsibility of management to properly document its plans and intentions relevant to specific assets or liabilities. While the assessment of management’s intent is a matter of professional judgment, the auditor undertakes procedures to support such assessment. Ordinarily, those procedures include inquiries of management, with appropriate corroboration of responses, for example, by:

- Comparing the results of inquiries with management’s past history of responding in similar situations.
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes, etc.
- Understanding and considering management’s business reasons for choosing a particular course of action.

The auditor also considers management’s ability to pursue a specific course of action if ability is relevant to the use, or exemption from the use, of fair value measurement under the entity’s financial reporting framework.

21. Where alternative methods for measuring fair value are available under the entity’s financial reporting framework, or where the method of measurement is not prescribed, the auditor should evaluate whether the basis of measurement is reasonable in the circumstances under the entity’s financial reporting framework.

22. Evaluating whether the basis of measurement is reasonable in the circumstances requires the use of professional judgment. When management is permitted to select one particular valuation method from alternatives, the auditor obtains an understanding of management’s rationale for its selection by discussing with management its reasons for selecting the valuation method. The auditor considers whether:

(a) management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the financial reporting framework to support the selected method;

(b) the valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity’s financial reporting framework; and

(c) the valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

23. In evaluating whether the basis of measurement is reasonable in the circumstances under the entity’s financial reporting framework, the auditor considers if management has determined whether different valuation methods indicate widely different conclusions about the fair value of the asset or liability. In such cases, the auditor understands and evaluates how the entity has investigated the reasons for any significant differences and whether the entity has established its measurement of fair value within an appropriate range of reasonable
considers whether the method selected by management is reasonable in the circumstances or whether different valuation methods need to be considered.

24. **The auditor should assess whether the entity’s fair value measurements and disclosures are applied consistently.**

25. Once management has selected a specific valuation method, the auditor assesses whether the entity has consistently applied that basis in its fair value measurement, and if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity, or changes in the requirements of the entity’s financial reporting framework. If management has changed the valuation method, the auditor considers whether management can adequately demonstrate that the valuation method to which it has changed provides an appropriate basis of measurement, or whether the change is supported by a change in the requirements of the entity’s financial reporting framework or a change in circumstances. For example, the introduction of an active market for a particular class of asset or liability may suggest that the use of discounted cash flows to estimate the fair value of such asset or liability may no longer be appropriate. The auditor considers whether the entity has complied with the accounting and disclosure requirements of its financial reporting framework relating to changes in the valuation method.

**Using the Work of an Expert**

26. The auditor may have the necessary skill and knowledge to plan and perform audit procedures related to fair values. The auditor, however, may decide to assign personnel with the necessary specialized skills or knowledge as a part of the audit team when the measurement of fair values is considered complex, or may decide to use the work of an expert.

27. **For measurements involving specialized techniques for determining fair value, the auditor should determine the need to use the work of an expert.** In making such a determination, the auditor considers the matters discussed in paragraph 7 of ISA 620, “Using the Work of an Expert.”

28. If the use of such an expert is planned, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, and complies with the requirements of ISA 620.

29. When planning to use the work of an expert, the auditor considers whether the expert’s understanding of the definition of fair value, or the method that the expert may use to determine fair value differs from that of management in reporting under the relevant financial reporting framework. For example, the method for estimating the fair value of real estate by a real estate appraiser, or the actuarial methodologies developed for making estimates of pension and insurance obligations, reinsurance receivables and similar items, may not be consistent with the measurement principles of the financial reporting framework. Accordingly, the auditor considers such matters when deciding to use the work of an expert.

30. In accordance with ISA 620, the auditor assesses the appropriateness of the expert’s work as audit evidence. While the appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert, the auditor obtains an understanding of the assumptions and methods used, and considers whether they are
the results of other audit procedures. Paragraphs 36 through 48 (see “Management’s Assumptions”) discuss the auditor’s evaluation of significant assumptions used by management, including assumptions relied upon by management based on the work of an expert.

Reviewing and Testing Management’s Process for Determining Fair Values

31. In order to obtain sufficient appropriate audit evidence as to whether the fair value measurements and disclosures in the financial statements are appropriate under the entity’s financial reporting framework, the auditor should review and test the process used by management for determining the fair values, including, where applicable, evaluating significant management assumptions.

32. Management is responsible for establishing a process for determining fair value measurements. In some cases, the measurement of fair value and therefore the process set up by management to determine fair value is 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 involve uncertainty about the occurrence of future events or their outcome, and therefore assumptions that may involve the use of judgment need to be made as part of the measurement process. The auditor’s understanding of the complexity involved in the measurement process helps determine the nature, timing and extent of the audit procedures. Appendix 2 to this ISA elaborates on certain considerations in reviewing and testing management’s process for determining fair value.

33. The auditor’s understanding of the reliability of the process used by management to measure fair value is an important element in support of the resulting amounts. A reliable method for determining fair value is one that results in reasonably consistent measurement and, where relevant, presentation and disclosure of fair value when used in similar circumstances. The auditor considers management’s process, including whether:

(a) management has used significant assumptions in determining fair value, and if so, whether the assumptions used are reasonable;

(b) the fair value measurement was prepared using an appropriate model, if applicable;

(c) the information used was the best information that was reasonably available at the time.

34. If the fair value measurements are developed on an ad hoc basis rather than as a part of a systematic process, such a fact may indicate a lack of management experience in generating such measurements. The effectiveness of the valuation process also depends on the expertise and experience of the people involved in the process, whether employed by the entity or external to it. Individuals external to the entity may include experts and service organizations engaged by the entity.

35. Estimation techniques and assumptions, the auditor’s consideration of fair value measurements prepared in prior periods, if any, and the reasons for significant variances between periods, may provide further evidence of the effectiveness and reliability of management’s processes. However, the auditor also considers whether such variances result from changes in economic circumstances.
Management’s Assumptions

36. **When significant assumptions are used by management in measuring fair value, the auditor should evaluate whether such assumptions, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity’s financial statements.**

37. It is necessary for management to make assumptions, including assumptions relied upon by management based upon the work of an expert, to develop many types of fair value measurements. Assumptions are integral components of more complex valuation methods, for example valuation models 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. Auditors pay particular attention to the significant assumptions underlying a valuation method or model and consider whether such assumptions are reasonable. To provide a reasonable basis for the fair value measurements and disclosures, assumptions need to be relevant, reliable, neutral, understandable and complete. Paragraph 45 of ISA 100, “Assurance Engagements” describes these characteristics in more detail.

38. For items valued by the entity using an internally generated model, the auditor is not expected to substitute his or her judgment for that of the entity’s management. Rather, the auditor reviews the model, and evaluates whether the assumptions used are reasonable. The auditor considers whether management has identified the significant assumptions and factors influencing the measurement of fair value, and whether the entity has made appropriate disclosures in accordance with its financial reporting framework.

39. Assumptions ordinarily are supported by differing types of evidence from internal and external sources that provide objective support for the assumptions used. The auditor assesses the source and reliability of evidence supporting management’s assumptions, including consideration of the assumptions in light of historical information and an evaluation of whether they are based on plans that are within the entity’s capacity.

40. Audit procedures dealing with management’s assumptions are performed in the context of the audit of the entity’s financial statements. The objective of these audit procedures is therefore not intended to obtain sufficient appropriate audit evidence to provide an audit opinion on the assumptions themselves. Rather, the auditor performs procedures to consider whether the assumptions provide a reasonable basis in measuring fair values in the context of the financial statements taken as a whole.

41. The auditor focuses attention on significant assumptions, in particular those assumptions 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) inconsistent with historical economic, industry or entity operating patterns;

   (c) inconsistent with assumptions made in prior periods; and
42. The consideration of whether the assumptions provide a reasonable basis for the fair value measurements relates to the whole set of assumptions as well as to each assumption individually. Assumptions are frequently interdependent, and therefore, need to be internally consistent. A particular assumption that may appear reasonable when taken in isolation may not be reasonable when used in conjunction with other assumptions. The auditor also considers whether the whole set of assumptions used by management is complete.

43. The assumptions on which the fair value measurements are based (for example, the discount rate used in calculating the present value of future cash flows) ordinarily will reflect what management expects will be the outcome of specific objectives and strategies. To be reasonable, such assumptions, individually and taken as a whole, also need to be realistic and consistent with:

(a) the general economic environment and the entity’s economic circumstances;

(b) the plans of the entity;

(c) past experience of, or previous conditions experienced by, the entity to the extent currently applicable; and

(d) other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for other financial statement accounts than those relating to fair value measurements and disclosures.

The greater the supporting evidence that exists for the assumptions and the more the assumptions reflect the execution of current management plans and actions, the greater the auditor’s confidence in the assumptions. Where assumptions are reflective of management’s intent to carry out specific courses of action, the auditor considers whether they are consistent with the entity’s plans and past experience (see paragraphs 19 and 20).

44. If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. While historical information can provide a benchmark for considering the reasonableness of management’s assumptions, the relevance of historical information may be reduced if management intends to engage in new activities or circumstances change.

45. The auditor considers the sensitivity of the valuation to changes in the assumptions, including market conditions that may affect the value. The auditor may encourage management to analyze possible ranges in fair value using such techniques as sensitivity analysis. In the absence of such management analysis, the auditor considers whether to employ such techniques as part of the audit process. The technique of developing ranges can assist in supporting the reasonableness of management’s fair value measurement. Ranges are especially meaningful when the effects of individual assumptions on the amounts in the range can be isolated for analysis.

46. In the absence of such management analysis, the auditor considers whether such techniques are to be employed by the auditor. If so, the auditor considers whether the variability in the ranges of fair value measurements is so great that a fair value might not be reasonably determinable. Wide differences in the results obtained from two or more valid estimating techniques alert the auditor to consider whether further investigation of the reliability of the
assumptions is warranted. The absence of wide differences in the results, however, does not, in and of itself, provide evidence about the reasonability of the assumptions.

47. **The auditor should evaluate whether the fair value measurements have been properly prepared from management’s assumptions.**

48. The auditor evaluates whether the fair value measurements have been prepared using management’s assumptions. This also may include, for example, audit procedures such as re-computation and reviewing of information for internal consistency, including whether such information is consistent with the auditor’s assessment of management’s intent to carry out specific courses of action discussed in paragraphs 19 and 20.

*Independent Fair Value Estimations*

49. The auditor may make an independent estimation of fair value, for example, by using a model developed by the auditor. The use of the auditor’s own models and data enables the auditor to develop an independent expectation to use in corroborating the reasonableness of the value calculated by the entity. When using an independent estimate the auditor evaluates the data, considers the assumptions and tests the calculations used in its development. The auditor considers the guidance contained in ISA 520, “Analytical Procedures” when performing these procedures during an audit.

*Subsequent Events*

50. **The auditor should consider the effect of subsequent events on the fair value measurements and disclosures in the financial statements.**

51. Transactions and events that occur after period-end but prior to completion of the audit, may provide audit evidence regarding the fair value measurements made by management. For example, a sale of investment property shortly after the period-end at a value similar to that estimated by management may provide audit evidence supporting the fair value measurement.

52. In the period after a financial statement period-end, however, circumstances may change from those existing at the period-end. The auditor exercises caution not to use fair value information after the period-end that may reflect events occurring after the period-end and not the circumstances existing at the balance sheet date. For example, the prices of actively traded marketable securities that change after the period-end ordinarily do not constitute appropriate audit evidence of the values of the securities that existed at the period-end. The auditor complies with ISA 560, “Subsequent Events” when evaluating audit evidence relating to such events.

*Disclosures about Fair Values*

53. **The auditor should evaluate whether the entity has made appropriate disclosures about fair values in conformity with its financial reporting framework.**

54. Disclosure of fair value information is an important aspect of financial statements in many financial reporting frameworks. Often, fair value disclosure is required because of the relevance to users in the evaluation of an entity’s performance and financial position. In
entities disclose voluntary additional fair value information in the notes to the financial statements or as required audited supplementary information.

55. When auditing fair value measurements and related disclosures included in the notes to the financial statements, whether required by the financial reporting framework or disclosed voluntarily, or as supplementary information, the auditor ordinarily performs the same types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements. The auditor obtains sufficient appropriate audit evidence that the valuation principles are appropriate under the entity’s financial reporting framework, are being consistently applied, are supported by underlying evidence, and the method of estimation and significant assumptions used are properly disclosed in accordance with the entity’s financial reporting framework. The auditor also considers whether voluntary information may be inappropriate in the context of the financial statements.

56. The auditor evaluates whether the entity has made appropriate disclosures about fair value information as called for by its financial reporting framework. If an item contains a high degree of measurement uncertainty, the auditor assesses whether the disclosures are sufficient to inform users of such uncertainty. For example, the auditor might evaluate whether disclosures about a range of amounts within which the fair value is reasonably believed to lie is appropriate under the entity’s financial reporting framework, when management considers a single amount presentation not sufficiently reliable.

57. When disclosure of fair value information under the applicable financial reporting framework is omitted because it is not practicable to determine fair value with sufficient reliability, the auditor evaluates the adequacy of disclosure of other information by management of possible differences between the carrying amount and fair value of reported amounts. If the entity has not appropriately disclosed fair value information required by the financial reporting framework, the auditor evaluates whether the financial statements are materially misstated by the departure from the financial accounting framework.

Evaluation of Results of Audit Procedures

58. In making a final assessment of the reasonableness of the fair value measurements and disclosures in the context of the financial statements taken as a whole, the auditor should evaluate the appropriateness of the audit evidence obtained.

59. When assessing the reasonableness of fair value measurements and disclosures, the auditor evaluates the consistency of the information and audit evidence obtained during the audit of fair value measurements with other audit evidence obtained during the audit. For example, the auditor considers whether there is or should be a relationship or correlation between the interest rate used to discount estimated future cash flows in determining the fair value of an investment property and mortgage interest rates currently being obtained by the entity to acquire investment property.

Management Representations

60. Where applicable, the auditor should obtain written representations from management regarding the reasonableness of management’s assumptions used in the valuation methods, and whether the fair value measurements and disclosures contained in the financial statements have been properly prepared from such assumptions, including whether they appropriately reflect management’s intent to
61. ISA 580, “Management Representations” discusses the use of management representations as audit evidence. Depending on the nature, materiality and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about:

- The reasonableness of the measurement methods used by management in determining fair value within the applicable financial reporting framework, and the consistency in application of the methods.
- The basis used by management to overcome the presumption relating to the use of fair value set forth under the entity’s financial reporting framework.
- The completeness and reasonableness of disclosures related to fair values under the entity’s 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

62. ISA 260, “Communication of Audit Matters with Those Charged with Governance” requires auditors to communicate audit matters of governance interest with those charged with governance. Because of the uncertainties often involved with some fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest. For example, the auditor considers communicating the nature of significant assumptions used in fair value measurements due to the significance of the assumptions to the 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. The auditor considers the guidance contained in ISA 260 when determining the nature and form of communication.

Effective Date

63. This ISA is effective for audits of financial statements for periods ending on or after June 30, 2003.

Draft Public Sector Perspective

1. Many governments are moving to accrual accounting and are adopting fair value as the basis of valuation for many classes of the assets and liabilities that they hold, or for disclosures of items in the financial statements. The broad principles of this ISA are therefore applicable to the consideration of the audit of fair value measurements and disclosures included in the financial statements of public sector entities.

2. Paragraph 3 of the ISA states that when fair value measurements and disclosures are material to the financial statements, the auditor should obtain sufficient appropriate audit evidence that such measurements and disclosures are in accordance with the entity’s identified financial reporting framework. The International Public Sector Accounting Standards accounting framework include a number of standards that require or allow the recognition or disclosure of fair values.

3. As noted in paragraph 7 of the ISA, determining the fair value of certain assets or liabilities may be complex where there is no active market. This can be a particular issue in the Public
assets held by public sector entities do not generate cash flows. In these circumstances a fair value or similar current value may be estimated by reference to other valuation methods including, but not limited to, depreciated replacement cost and indexed price method.
Appendix 1

Fair Value Measurements and Disclosures under Different Financial Reporting Frameworks

1. Different financial reporting frameworks require or permit a variety of fair value measurements and disclosures in financial statements. They also vary in the level of guidance that they provide on the basis for measuring assets and liabilities or the related disclosures. Some financial reporting frameworks give prescriptive guidance, others give general guidance, and some give no guidance at all. In addition, certain industry-specific measurement and disclosure practices for fair values also exist.

2. Different definitions of fair value may exist among financial reporting frameworks, or for different assets, liabilities or disclosures within a particular framework. For example, International Accounting Standard (IAS) 39, “Financial Instruments: Recognition and Measurement” defines fair value as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction”. The concept of fair value ordinarily assumes a current transaction, rather than settlement at some past or future date. Accordingly, the process of measuring fair value would be a search for the estimated price at which that transaction would occur.

3. Different financial reporting frameworks may treat changes in fair value measurements that occur over time in different ways. For example, a particular financial reporting framework may require that changes in fair value measurements of certain assets or liabilities be reflected directly in equity, while such changes might be reflected in income under another framework. In some frameworks, the determination of whether to use fair value accounting or how it is applied is influenced by management’s intent to carry out certain courses of action with respect to the specific asset or liability.

4. Different financial reporting frameworks may require certain specific fair value measurements and disclosures in financial statements and prescribe or permit them in varying degrees. The financial reporting frameworks may:
   - Prescribe measurement, presentation and disclosure requirements for certain information included in the financial statements or for information disclosed in notes to financial statements or presented as supplementary information.
   - Permit certain measurements using fair values at the option of an entity or only when certain criteria have been met.
   - Prescribe a specific method for determining fair value, for example, through the use of an independent appraisal or specified ways of using discounted cash flows.
   - Permit a choice of method for determining fair value from among several alternative methods (the criteria for selection may or may not be provided by the financial reporting framework).
   - Provide no guidance on the fair value measurements or disclosures of fair value other than their use being evident through custom or practice, for example, an industry practice.

5. Some financial reporting frameworks presume that fair value can be measured reliably for
or disclosures. In some cases, this presumption may be overcome when an asset or liability does not have a quoted market price in an active market and for which other methods of reasonably estimating fair value are clearly inappropriate or unworkable.

Prevalence of Fair Value Measurements

6. Measurements and disclosures based on fair value are becoming increasingly prevalent in financial reporting frameworks. Fair values may occur in, and affect the preparation of, financial statements in a number of ways, including the measurement at fair value of:

- Specific assets or liabilities, such as marketable securities or liabilities to settle an obligation under a financial instrument.
- Specific components of equity, for example when accounting for the recognition, measurement and presentation of certain financial instruments with equity features, such as a bond convertible by the holder into common shares of the issuer.
- Specific assets or liabilities acquired in a business combination. For example, the initial determination of goodwill arising on the purchase of an entity in a business combination usually is based on the fair value measurement of the identifiable assets and liabilities acquired and the fair value of the consideration given.
- Specific assets or liabilities adjusted to fair value on a one-time basis. Some financial reporting frameworks may require the use of a fair value measurement to quantify an adjustment to an asset or a group of assets as part of an asset impairment determination, for example, a test of impairment of goodwill acquired in a business combination based on the fair value of a defined operating entity or reporting unit, the value of which is then allocated among the entity’s or unit’s group of assets and liabilities in order to derive an implied goodwill for comparison to the recorded goodwill.
- Aggregations of assets and liabilities. In some circumstances, the measurement of a class or group of assets or liabilities calls for an aggregation of fair values of some of the individual assets or liabilities in such class or group. For example, under an entity’s financial reporting framework, the measurement of a diversified loan portfolio might be determined based on the fair value of some categories of loans comprising the portfolio.
- Transactions involving the exchange of assets between independent parties without monetary consideration. For example, a non-monetary exchange of plant facilities in different lines of business.
- Information disclosed in notes to financial statements or presented as supplementary information, but not recognized in the financial statements.
Appendix 2

Certain Considerations in Reviewing and Testing Management’s Process for Determining Fair Values

1. Because of the wide range of possible fair value measurements, from relatively simple to complex, the auditors planned audit procedures can vary significantly in nature, timing and extent. The paragraphs below elaborate on certain considerations in reviewing and testing management’s process for determining fair values.

2. The existence of published price quotations in an active market ordinarily is the best evidence of fair value. Some fair value measurements, however, are inherently more complex than others. Complex fair value measurements normally are characterized by greater uncertainty regarding the reliability of the measurement process, the complexity and subjectivity of assumptions associated with the process, the availability of relevant data, the number of significant assumptions made, and the degree of uncertainty associated with such assumptions. This complexity arises either because of the nature of the item being measured at fair value, or because of the valuation method required by the financial reporting framework or selected by management. For example, in the absence of quoted prices in an active market, some financial reporting frameworks permit an estimate of fair value to be based on an alternative basis such as a discounted cash flow analysis or a comparative transaction model.

3. The auditor’s understanding of the complexity involved in the measurement of fair value helps guide the auditor’s assessment of detection risk and, accordingly, the nature, timing and extent of audit procedures to be performed. For example:

   • Using a price quotation to test valuation may require an understanding of the circumstances in which the quotation was developed. For example, quotations provided by a counterparty to an option contract involving a derivative financial instrument may not be based on recent trades and may be only an indication of interest in a possible transaction.

   • When using evidence provided by a third party, for example, information obtained through the use of external confirmations, the auditor evaluates the competence, independence, authority, knowledge of the matter, and objectivity of the third party in order to be satisfied with the reliability of the evidence. The extent of such procedures will vary according to the audit risk associated with the fair value measurements. The auditor complies with ISA 505, “External Confirmations” in this regard.

   • Evidence supporting fair value measurements (for example, a valuation by an independent appraiser) may be obtained at a date that does not coincide with the date at which the entity is required to measure and report that information in its financial statements. In such cases, the auditor considers whether management has taken into account the effect of events, transactions and changes in circumstances occurring between the date of fair value evidence and the reporting date in determining the appropriateness of the evidence and how it will be used in preparing the financial statements.

   • Collateral often is assigned for certain types of investments in debt instruments that either are required to be measured at fair value or are evaluated for possible
investment or evaluating its carrying amount, the auditor obtains sufficient appropriate audit evidence regarding the existence, value, rights and access to or transferability of such collateral, and considers whether appropriate disclosures about the collateral have been made under the entity’s financial reporting framework.

- In some situations, additional procedures, such as the inspection of an asset by the auditor, may be necessary to obtain sufficient appropriate audit evidence about the appropriateness of a fair value measurement. For example, inspection of an investment property or a work of art may be necessary to obtain information about the current physical condition of the asset relevant to its fair value, or inspection of a security may reveal a restriction on its marketability and may therefore affect its value.

4. Some financial reporting frameworks require certain specified adjustments or modifications to valuation information, or other considerations unique to a particular asset or liability. For example, accounting for investment properties may require adjustments to be made to an appraised market value, such as adjustments for estimated closing costs on sale, adjustments related to the property’s condition and location, and other matters. Similarly, if the market for a particular asset is not an active market, published price quotations may have to be adjusted or modified to arrive at a more suitable measure of fair value. For example, quoted market prices may not be indicative of fair value if there is infrequent activity in the market, the market is not well established, or small volumes of units are traded relative to the aggregate number of trading units in existence. Accordingly, such market prices may have to be adjusted or modified. Alternative sources of market information may be needed to make such adjustments or modifications, or the auditor may need to use the work of an expert to resolve the valuation for use in the financial statements.

5. Specified adjustments or modifications to valuation information or other considerations unique to a particular asset or liability often are based on a combination of subjective and objective factors. As a result, judgment is required to estimate an appropriate amount for use in the financial statements. Subjective factors involve varying degrees of uncertainty or the absence of objective data. Even when management’s estimation process involves competent personnel using relevant and reliable data, there is potential for bias when management is required to consider subjective factors. Accordingly, when planning and performing procedures to evaluate fair value measurements, the auditor considers subjective factors used by management that are significant to the determination of fair value.