BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Mr Jim Sylph
Technical Director
International Federation of Accountants
535 Fifth Avenue, 26th Floor
New York, New York 10017
USA

15 January 2002

Re: Auditing Fair Value Measurements And Disclosures: Proposed International Standard on Auditing

Dear Mr Sylph,

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the Exposure Draft of "Auditing Fair Value Measurements And Disclosures", which the International Auditing Practices Committee published for comment in October 2001. The Committee has a strong interest in promoting high quality audits of banks and has carefully reviewed the Exposure Draft of this proposed International Standard on Auditing in this light.

Please find our detailed comments in the attached note. The note has been prepared by the Committee's Accounting Task Force, chaired by Prof Arnold Schilder, Executive Director of De Nederlandsche Bank.

If you have any questions regarding our comments, please feel free to contact Prof Schilder (+ 31 20 524 3360), Deborah Chesworth of the Financial Services Authority in London (+ 44 207 676 3880), or Bengt A Mettinger at the Basel Committee Secretariat (+ 41 61 280 9278).

Yours sincerely,

William McDonough

Exposure Draft of a proposed International Standard on Auditing on 'Auditing Fair Value Measurements and Disclosures'

Introduction

The Basel Committee on Banking Supervision ('the Committee') recognises that auditors are faced with many difficult challenges in the audit of fair value measurements and disclosures and therefore welcomes the International Auditing Practices Committee's ('IAPC') initiative to provide guidance on this subject.

Irrespective of the particular accounting framework employed, fair values are becoming increasingly prevalent in measurements of and disclosures about financial instruments and for that reason the subject is of particular concern to banking supervisors. Equally, however, this is a broad-ranging subject, both in the types of transactions and instruments that may be subject to fair value measurement for accounting or disclosure purposes, and in the techniques that may be used to establish that value.

General observations

The Committee believes that the primary need is to provide auditors with appropriate *practical* guidance that will help them in the audit of this area and is not convinced that an International Standard on Auditing ('ISA') is necessarily the best way to address that need.[1]

The Committee observes that many of the 'black letter' principles and procedures set out in the Exposure Draft ('ED') essentially duplicate the provisions of existing ISAs. On the other hand, the 'black letter' material in the ED that is new (in the sense that it does not duplicate other ISAs) contains important principles and procedures on accounting estimates and would be equally relevant to other, non-fair value estimates. We understand, furthermore, that, in recognition of the fact that the format of an ISA does not facilitate the provision of practical guidance, the IAPC intends in due course to develop one or more International Auditing Practice Statements on various aspects of fair value measurements and disclosures.

The IAPC may want to consider other options for dealing with this subject. One possible approach could be to:

- provide a broad context by strengthening ISA 540, 'Audit of Accounting Estimates' to incorporate those principles from the ED that are relevant to accounting estimates in general;
- develop an International Auditing Practice Statement to provide practical guidance on the audit of fair value measurements and disclosures;[2] and

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[1] It seems from the recent Consultative Advisory Group ('CAG') meeting in Madrid that the IAPC may have gained the impression that CAG members had specifically requested the development of a *standard* on fair value. Whilst encouraging the development of guidance on this subject, the Committee has no fixed views about the particular form which that guidance should take.

- if necessary, develop annexes to the Practice Statement to deal with the specific issues that may arise in relation to particular businesses or types of assets, liabilities and components of equity.[3]

In addition, further development work on guidance on the audit of fair values could usefully take into account some of the material contained in International Auditing Practice Statement ('IAPS') 1012, 'Auditing Derivative Financial Instruments'. For instance, the practice statement contains material (in paragraphs 80 to 86) covering measurement aspects, some of which could usefully be incorporated into more general guidance on fair values.

Finally, on the structure of the ED, the Committee believes that auditors might be able to more effectively use the final document if, in appropriate places, it dealt separately with the different techniques for fair value assessment. For example, the issues that auditors are likely to face in dealing with fair values based on market prices or (external or internal) appraisal values may be very different from those arising in connection with items that are 'marked to model'.

Particular aspects of fair value measurements and disclosures on which further guidance would be helpful

Documentation

Admittedly, documentation is a difficult subject in the context of fair value. It is however important that management appropriately document its processes for designating items and for calculating fair values, the various assumptions on which the calculations are based, and the actual calculations themselves. We believe that the ED should emphasise that management is responsible for preparing such documentation, and that more emphasis could be placed on documentation as audit evidence throughout the ED. It would also be helpful to include guidance on appropriate audit procedures when such documentation is not available. (Examples of areas to which this comment is particularly relevant include paragraphs 22 and 25.) Finally on this subject, it might also be helpful to remind auditors of their own responsibilities to document matters that are important in providing evidence to support their opinion, in accordance with ISA 230.

Compliance with the entity's identified financial reporting framework

The material in the ED (paragraphs 3 to 8) focuses largely on two issues: (i) a brief discussion of the differences in various accounting frameworks; and (ii) whether or not the assets, liabilities and equity components that the entity has fair valued are eligible for such a treatment under the relevant accounting framework. It may, however, be equally important for the auditor to assess whether there are items that should have been measured or disclosed on a fair value basis but have not been. It would be helpful to include guidance on this subject.

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[2] It would also be easier in a Practice Statement to highlight other ISAs that are particularly relevant to the audit of fair values such as ISAs 310 (Knowledge of the Business), 320 (Audit Materiality) and 570 (Going Concern).

[3] In relation to this point, it appears that the ED is intended to cover fair values whenever they are used in the measurement or disclosure of any asset, liability or component of equity. We agree with that approach but the Introduction to the ED could be clearer on this point, perhaps by incorporating some of the material contained in Appendix 1 to the ED, particularly the examples in paragraph 6.

We have two further comments on these paragraphs:

- paragraph 4 should explain the auditor's responsibilities as well as those of management
- we do not understand the distinction between paragraphs 3 and 14. It may be that paragraph 3 is simply an introductory sentence, in which case it should perhaps be in plain type rather than bold. (In addition, some of paragraph 15 does not seem to be directly relevant to paragraph 14, and its first sentence should be clarified to emphasise that the auditor needs to understand the business well enough to make the required assessment.)

Understanding internal control

Paragraph 10 of the ED summarises some of the relevant internal control considerations related to fair values but it is by no means a comprehensive list. Particularly in a banking or other financial services environment, where fair value outcomes are likely to have a very significant impact on the financial statements, the processes for their assessment would usually be surrounded by extensive internal controls. As well as expanding the material to provide further guidance on the matters listed in paragraph 10, other points could usefully be covered such as:

- segregation of duties between those undertaking the valuations and those responsible for committing the entity to the underlying transactions;
- the remuneration structure for those responsible for determining fair values;
- the integrity of, and the approval, change control and security procedures for, models and other relevant information systems;
- controls over the consistency, timeliness and reliability of data sources used to provide model inputs; and
- where appropriate, procedures to 'backtest' fair values by reference to subsequent market transactions.

Assessing management's intent

Paragraph 20 rightly points out that management's ability to pursue a specific course of action may be a relevant consideration in determining the appropriateness or otherwise of fair value measures. This is particularly applicable when auditors are reviewing whether items that have not been fair valued should have been. This issue can be difficult and deserves more than a passing reference in the ED; for instance, auditors may need to review the entity's financial position, projected cash flows, contractual obligations and so forth in order to obtain the appropriate degree of assurance that it has the capacity to carry out management's intentions.

Reasonableness of the basis of measurement

As a general comment on paragraphs 21 to 23, we think that auditors should focus on the 'appropriateness' of the basis of measurement, as well as its 'reasonableness'. This observation, which also applies to other sections of the ED[4], reflects a broader concern that

[4] See, for instance, the second paragraph under 'Management's assumptions' below.

the document could as a whole be read as implying a fairly passive, accepting approach to the audit of fair values. Clearly, this is not the right impression: auditors should approach fair values with the same (if not more) professional scepticism as they would apply to other aspects of the financial statements. They should challenge management's assertions, assumptions and choices (of models, pricing sources and so forth) and should be prepared to carry out independent estimates of fair value where that is the more effective and/or efficient way of obtaining the appropriate level of audit evidence[5].

Paragraph 22 points out that, as well as considering management's process for evaluating the various options, the auditor should make his own assessment of the 'reasonableness' of the method chosen. The following paragraph, however, deals only with the review of management's process and there is no guidance to help auditors to make their own assessment. This judgement can be difficult and the lack of guidance is a major omission in the ED. It would be particularly helpful to discuss in this section matters such as:

- the relative merits of market prices, appraisals, discounted cash flows and other valuation models;
- the adjustments that may be needed when the fair value of an instrument is calculated on the basis of the market price for a similar instrument; and
- the circumstances under which market prices for an instrument may need adjustment in order to arrive at a fair value. We recognise that different accounting frameworks permit or require different value adjustments (e.g., liquidity, close-out costs, size of position, and model error), but it would be useful to provide guidance to auditors when they do have to review these elements.

Appendix 2 to the ED constitutes a good starting point and this expanded material could be incorporated into this section.

Consistency

Because there is rarely a single 'right' answer, consistency is a very important element of all aspects of fair value measurements and disclosures. This consideration applies from the accounting framework through matters such as the relative treatments of assets and liabilities and of particular items in the financial statements and the fair value methods chosen down to the assumptions used, the internal workings of a particular model, the value adjustments made to market prices and the sources of market prices and model inputs. More guidance on this subject would therefore be a valuable addition to the ED.

Assessment of management's process for determining fair values

Paragraph 35 could usefully be expanded and clarified. In particular, there is a reference to 'estimation techniques and assumptions' but no guidance is given to help the auditor understand what he should be considering in order to provide audit evidence about the effectiveness and reliability of management's process. In addition, the reference to 'the auditor's consideration of … reasons for significant variances between periods' needs further explanation. Such a review may be appropriate in relation to some assets such as real estate but, in many contexts (particularly in relation to financial instruments), these techniques need

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[5] On this point, it would also be helpful if the ED could include guidance on appropriate procedures if the auditor's fair value estimates are significantly different from those derived by management.

to be used with caution particularly when the entity does not itself undertake this analysis as part of the production of management information.

Management's assumptions

The assessment of management's assumptions in order to support the appropriateness of the resulting fair values is another difficult area for auditors. Much of the material in this part of the ED focuses on helping auditors to identify the most important assumptions and therefore the focus of their work. There is, however, very little in the way of practical guidance on the sort of evidence that the auditor might use to assess those assumptions (although paragraphs 43 and 44 provide a few pointers). On a specific point, the assessment of expected future cash flows can be particularly difficult and further material on this subject would be very welcome. Another important question for auditors to address is the degree of conservatism or otherwise inherent in the assumptions chosen by management.

In addition, we suggest that the first two sentences of paragraph 38 should be re-drafted. As they stand, they are rather passive and could be misinterpreted as suggesting that the auditor should not challenge management's assumptions; paragraph 84 of IAPS 1012 states the position rather more clearly. We also note that this material suggests that the purpose of the auditor's review of assumptions is to establish whether or not they are 'reasonable'. We think that the auditor should also be focusing on their appropriateness.

Evaluation of the results of audit procedures

Fair value measurement and disclosure is an area where it is particularly important for the auditor to evaluate the overall evidence gathered to ensure that, taken together, it is both sufficient and appropriate. It would be helpful to stress this point in the document.