acuitas, inc.’s survey of fair value audit deficiencies

April 2012
Executive Summary

Public Company Accounting Oversight Board (PCAOB) inspections have noted a dramatic increase in the number of fair value measurement (FVM) audit deficiencies relating to impairment testing and the measurement of certain assets, particularly the pricing of financial instruments. Acuitas, Inc.’s Survey of Fair Value Audit Deficiencies is intended to assist financial statement preparers, auditors, and valuation specialists in understanding the underlying causes of FVM and impairment audit deficiencies, as reported by the PCAOB in their latest inspection reports. The information contained in the study should benefit public entities and their auditors, and by extension, private entities and their auditors.

In a year over year comparison of firms subject to annual inspection, 2010 PCAOB inspections indicate two significant trends. 1) The percentage of overall audits with deficiencies has more than doubled in 2010, compared to 2009. 2) FVM and impairment audit deficiencies have contributed significantly to this increase. FVM and impairment deficiencies accounted for 53% of all audit deficiencies cited in 2010 PCAOB inspection reports and the number of these deficiencies cited has increased by more than three times since 2009.

The survey also examines the underlying causes of FVM and impairment audit deficiencies. Recent PCAOB reports indicate that most FVM related audit deficiencies (49.5%) resulted from inadequate testing asset prices provided by outside pricing services. Most impairment related audit deficiencies (64.5%) were related to the testing of managements’ prospective financial information.
Audit Deficiencies Increase in Difficult Economic Times

Audit deficiencies attributable to fair value measurements (FVM) and impairment audit procedures are on the rise, which is apparent from the latest inspection reports issued by the Public Company Accounting Oversight Board (PCAOB). The increase in audit deficiencies related to FVM and impairment are consistent with a general increase in all audit deficiencies, and is a likely result of uncertainty created by the economic downturn. FVM and impairment audit deficiencies are particularly significant because these two particular issues account for over half of all recent audit deficiencies. Auditing the estimates and assumptions underlying FVM and impairments requires heightened professional skepticism as these judgmental areas are susceptible to management bias, particularly in difficult economic times.1

The purpose of the survey of PCAOB inspection reports is to help financial statement preparers, auditors, and valuation specialists understand the ultimate causes of FVM and impairment audit deficiencies and failures, according to the PCAOB. The purpose is also to note trends in the PCAOB inspection findings, in aggregate. The information contained in the study should be of benefit not only to public entities and their auditors, but by extension, to private entities and their auditors. The survey begins with a brief overview of the PCAOB inspection process and the survey methodology. The next section examines trends in audit deficiencies by looking at statistics over a three year period. Finally, the survey provides information about the specific causes of FVM and impairment audit deficiency.

1 PCAOB Staff Audit Practice Alert No. 9, Assessing and Responding to Risk in the Current Economic Environment, December 6, 2011.
**PCAOB Inspections**

The PCAOB conducts inspections of registered public accounting firms as required by the Sarbanes-Oxley Act of 2002. The inspections are designed to identify and address deficiencies in a firm's audit engagements and to determine whether deficiencies indicate a weakness or defect in the firm's system of quality control over audits. The annual inspection process encompasses a review of selected audits and a review of the firm's system for quality control.

PCAOB reviews of selected audits are intended to identify financial statement misstatements, including failures to comply with disclosure requirements and failures to perform applicable audit procedures. When a deficiency reaches a level of significance that appears to indicate the firm failed to obtain sufficient audit evidence to support its audit opinion on the financial statements or on the effectiveness of internal control over financial reporting, the deficiency is described in the PCAOB's inspection report, which is publicly available.

The PCAOB performs annual inspections of firms that regularly provide audit reports for more than 100 issuers. The largest international auditing firms, Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP (“the Big Four”) are among the firms inspected annually. For smaller auditing firms that audit public registrants, the PCAOB conducts inspections at least every three years. By the end of 2011, the PCAOB had released only four of the ten 2010 inspection reports for firms subject to annual inspection. While the PCAOB inspection reports are silent about the financial statement dates of the audit engagements examined, the PCAOB's field work generally begins just after the audit season in February or March, and extends through October or November. Therefore, it appears likely that 2010 inspection reports relate to audits of 2009 financial statements.
Methodology

The Survey of Fair Value Measurement and Impairment Audit Deficiencies from PCAOB Inspection Reports was prepared using a two-fold approach. First, in order to analyze general trends in audit deficiencies, we examined the PCAOB’s 2008, 2009 and 2010 inspection reports for firms subject to annual inspection. Because the PCAOB has only issued four of its 2010 annual inspection reports to date, the trend analysis includes data for Deloitte & Touche LLP, Ernst & Young LLP, KPMG LLP and PricewaterhouseCoopers LLP. The PCAOB performed field work at each of the four firms’ national offices and in 129 (46.6%) of the firms’ practice offices, and reviewed aspects of 242 audits and 8 other engagements.

The second part of the survey focuses on FVM and impairment audit deficiencies. All of the 2008 to 2010 PCAOB inspection reports available for the top 25 public accounting firms were examined. Of the 45 available inspection reports, 21 had FVM and impairment audit deficiencies. The PCAOB provides a brief description of the type of audit failure and the underlying cause. For each report, the PCAOB generally presents each deficiency as a separate bullet point. In the survey, each deficiency was counted separately and was categorized based on the type of audit failure. FVM deficiencies were categorized into financial instruments, pension plans and business combinations, and impairment deficiencies were categorized into those attributable to goodwill, asset groups and intangible assets. The underlying causes were tallied and audit deficiency statistics were calculated.

Description of a Deficiency

Auditing Standard No. 7 *Engagement Quality Review* provides a description of a significant audit engagement deficiency as “exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client.”

2 PCAOB Auditing Standard No. 7 *Engagement Quality Review*
Audit Deficiency Trends

The PCAOB inspections for the four firms with reports available in 2008, 2009 and 2010 indicate two trends. First, the percentage of audit engagements with deficiencies has more than doubled since 2009. In connection with the four 2010 annual inspections, the PCAOB found deficiencies in 79 issuers, or 31.6% of audits reviewed. In 2009, the inspection reports for the same four firms cited deficiencies in 36 issuers, or 13.5% of audits reviewed. The average number of deficiencies per issuer has also increased from 1.4 in 2008, to 2.0 in 2009 and 3.0 in 2010.

3 The percentage of audit engagements with deficiencies is not available for 2008.
A second trend indicates that FVM and other deficiencies have increased dramatically. In 2008, there were 11 FVM deficiencies, 11 impairment deficiencies and 20 other deficiencies. By 2010, there were 92 FVM deficiencies, 31 impairment deficiencies and 111 other deficiencies for the four firms.

![Deficiency Trends](chart.jpg)

The economic crisis has likely been the primary cause of the increase in audit deficiencies. Economic volatility affected entities income from underlying operations and caused other changes in fair value, which introduced additional risk and uncertainty to the audit process. Hard-to-value financial instruments like asset backed securities, collateralized debt obligations, and other collateralized mortgage obligations were at the heart of the financial crisis and pricing information was not readily available. In addition, the number of companies experiencing goodwill and long-lived asset impairment triggering events also increased during the economic crisis. Impairment testing relies on projected financial information (PFI) which becomes more difficult to assess in uncertain times. The value of goodwill impairments for U.S. companies peaked in 2008 at $188 billion, and then dropped off dramatically to $26 billion in 2009[^4]. Impairment deficiencies were cited less frequently in 2010 inspection reports relative to other deficiencies, which is likely due to the drop off of goodwill impairment write offs in 2009.

FVM Deficiencies

In all three years, FVM deficiencies were primarily attributable to financial instruments; however the percentage increased from 51.6% in 2008 to 88.0% in 2010. Deficiencies relating to pension plan audits accounted for 29.0% of FVM deficiencies in 2008 and 6.5% in 2010, but there were no pension plan audit deficiencies identified in 2009. Business combinations were the source of 19.4% of FVM deficiencies in 2008, but declined to 5.4% in 2010.

Pricing issues were the primary cause of FVM audit deficiencies in the three year period examined, and they accounted for 49.5% of deficiencies in 2010. Failure to adequately test FVM was the secondary cause of deficiencies. Disclosure deficiencies were higher in 2010 than in previous years. One reason is disclosure requirements of Financial Accounting Standards Board Accounting Standards Codification 820, *Fair Value Measurement* became effective for financial instruments in 2008 and for other assets in 2009. Due to the lag time between the audit report and the PCAOB inspection report, these deficiencies did not become a significant factor until the 2010 inspections. Prospective financial information deficiencies relate to forecasts used to measure the fair value of intangible assets in business combinations. The decline in PFI deficiencies in 2010 mirrors the decline in the number of business combination deficiencies in 2010. More specific descriptions of these FVM audit deficiencies taken from the PCAOB inspection reports are provided on the following page.

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**2010 FVM Deficiencies**

- Financial Instruments: 88.0%
- Business Combinations: 5.4%
- Pension Plans: 6.5%

**2008 & 2009 FVM Deficiencies**

- Financial Instruments: 70.3%
- Business Combinations: 17.6%
- Pension Plans: 12.2%

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**2010 FVM Deficiency Causes**

- Pricing: 49.5%
- Failure to Test: 20.4%
- Disclosures: 11.8%
- Risk Assessment/Controls: 4.3%
- PFI Assumptions: 3.2%
- OTTI Classification: 10.8%

**2008 & 2009 FVM Deficiency Causes**

- Pricing: 37.8%
- Failure to Test: 27.0%
- Disclosures: 16.2%
- Risk Assessment/Controls: 5.4%
- PFI Assumptions: 1.4%
Description Of Fair Value Measurement Deficiencies

Pricing – Includes failure to understand the methods, models and assumptions used by pricing services or valuation specialists; using the same pricing service to corroborate prices that the issuer used when measuring fair value; failure to investigate significant differences between prices from different sources; failure to investigate pricing differences identified by internal audit; failure to investigate adjustments made to third party prices by issuers; and inappropriately applying the yield or discount rate from one population to test securities prices or values in the test population without assessing the comparability of the two groups.

Failure to Test – Includes relying on interim testing and failing to test the assertion there was no material change in value; relying on interim testing and failing to perform procedures at year end; failing to perform sufficient substantive procedures when significant risks are identified; failing to perform year end tests when broker quotes were older than 30 days; failing to perform substantive tests when too much reliance is placed on internal controls or internal audit; failure to assess whether all assets and liabilities had been identified in a business combination; failure to test data provided to outside valuation specialist; failure to test the accuracy and completeness of data that valuation specialists relied on; failure to test fair value when requested pricing information was not received; failure to test all items in a selected sample; and outright failure to test certain assets and liabilities.

Disclosures – Includes failure to identify and test controls over FVM hierarchy disclosures; failure to test FVM hierarchy classification as Level 2 or Level 3; and failure to assess whether an input is observable or unobservable when testing the FVM hierarchy classification.

Risk Assessment / Controls – Includes the failure to identify and test controls over inputs to FVMs; setting risk thresholds so high that material errors are not detected; failure to investigate controls over resolution of pricing differences; failure to identify weakness due to lack of supervision by qualified personnel in the testing of hard-to-value financial instruments; failure to test controls over the budgetary process; and failure to test controls over the classification of securities as available for sale.

Projected Financial Information (PFI) Assumptions – Includes failure to evaluate the reasonableness of assumptions relating to revenue growth rates, capital expenditures, terminal growth rates and the discount rate; failure to assess the reasonableness of improved margins; failure to consider industry growth rates; erroneously using PFI from a period prior to a reorganization; failure to evaluate customer attrition rates; failure to evaluate the risk premium in the issuer’s weighted average cost of capital; failure to evaluate a significant difference between value indications from the market and income approaches; and failure to assess a change in weights assigned to various indications of value.

Other Than Temporary Impairment (OTTI) – Includes failure to test controls over the classification of securities as OTTI; failure to test the issuers’ evaluation of securities as potentially OTTI; and failure to evaluate the assumptions, calculations and completeness of the issuer’s OTTI test.
Impairment Deficiencies

While the number of impairment deficiencies increased modestly over the three year period, they were dominated by those related to goodwill impairments in all three years with 48.4% in 2010, 70.6% in 2009 and 54.5% in 2008. Most of the remaining impairment deficiencies relate to long lived asset groups, but there were deficiencies attributable solely to intangibles assets each year.

The underlying causes of audit deficiencies related to impairment tests are shown in the following graphs. While the underlying causes for impairment deficiencies are similar to those underlying FVM deficiencies, pricing and disclosure deficiencies were not represented in impairment audit failures. Conversely, asset mismatch failure was a cause of impairment deficiencies, but not FVM deficiencies. More specific descriptions of these impairment audit deficiencies taken from the PCAOB inspection reports are provided following the Impairment Deficiency Causes graphs.
Descriptions of Impairment Deficiencies

PFI Assumptions – In addition to the PFI assumption deficiencies mentioned for FVM, a deficiency relating to the failure to test the model, inputs and assumptions used to value a loan portfolio in connection with a goodwill impairment analysis was identified.

Risk Assessment / Controls – Additional deficiencies were failure to assess the issuer's methodology for determining fair value of reporting units, failure to identify deficiencies in controls relating to triggering events; and failure to assess whether the timing of impairment charge was appropriate.

Failure to Test – An additional deficiency was failure to test the issuer's assertion that assets were not impaired and ignoring evidence that triggering events had occurred.

Asset Mismatch – Including failure to identify a mismatch between the group of assets being tested for impairment and the group of assets included in the calculation of carrying value; and failure to identify an issuer's departure from GAAP by allocating goodwill to reporting units.
Concluding Thoughts

Based on data compiled from PCAOB 2008 – 2010 inspection reports issued through the end of 2011, it is apparent that audit deficiencies increased dramatically. A significant cause of the increase in the number of deficiencies found in PCAOB inspection reports relate to the auditing of fair value measurements. One cause of the increase deficiencies related to fair value measurements is the increase in the complexity of audits resulting from the recent economic crisis. Measuring the fair value of financial instruments in particular, as well as testing various assets for impairment became increasingly difficult during this uncertain period. The inspection reports indicate that audit deficiencies relating to financial instruments were primarily caused by pricing problems and the failure to adequately test the value. The reports also noted that audit deficiencies relating to impairments generally resulted from failure to adequately test management's PFI.

Professional judgment is required in both the audits being examined, and the PCAOB inspection process. Professionals may reach different conclusions as to the adequacy of the audit process. PCAOB inspection deficiencies relate to the audit process itself, and not necessarily to the reliability of the underlying financial information. This study is a summary of publicly available information, the purpose of which is to highlight trends in audit deficiencies related to fair value measurements. A more complete presentation of the underlying data can be found in the inspection report themselves.

The dramatic rise in audit deficiencies seen in the 2010 inspection reports issued to date also appears to have put the PCAOB behind schedule. Look for updates to this survey when the PCAOB issues its findings on the remaining firms subject to annual inspection.

Acuitas, Inc.

Acuitas, Inc. is an Atlanta, Georgia based valuation and decision consulting firm. Additional information about our firm can be found at www.acuitasinc.com.

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