CHALLENGES INCURRED IN THE AUDITING OF FAIR VALUE MEASUREMENTS

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Abstract:

The purpose of the auditors' work is to establish confidence between the producers and users of accounting information. Thus, auditors help protect the interests of different categories of beneficiaries of accounting information when they make economic decisions. The prevalence of fair values in the financial statements as their inherent measurement uncertainty has increased dramatically in recent years and is recognized as representing a significant problem for regulators. In these circumstances we ask which are the difficulties encountered by auditors in auditing fair values, what kinds of deficiencies they find within auditing and whether the complexity of measurements of fair value jeopardizes the ability of auditors to give a highly secure opinion.

Keywords: Audit, measurement, fair value

JEL Classification: M40, M41, M42

1. Introduction

The main objective of this article is the presentation of certain aspects related to the fair value measurement according to the International Standard of Financial Reporting, Assessment Standards and the Order of the Ministry of Public Financers n. 1802 / 2014.

Generally, the term "*audit*" comes from the Latin word "audire', to listen and to inform the others; in the nowadays Anglo-Saxon countries, this term means a review of the accounting and other information, performed by an independent professional, in order to express an opinion on the regularity and honesty of the audited information (Toma 2006:14)

„The exertion of audit is based on certain reference norms based on which the auditor sets the objectives to be reached and establishes the most suitable investigation techniques." (Briciu, 2006: 439) Considering that more and more assets and liabilities are measured at their fair value, the auditors and normalizers must understand not only the measurement models and processes through which the management has determined the entry data of the used model, but also possible predispositions and management errors in the application of models, the identification of the data for entering the market and the hypothesis issue. The auditors and normalisers also have to understand which are the most probable sources of distortions and errors that appear during the auditing of fair values recognised in the financial situations.

The auditing of fair values is approached by a very small number of studies. This research gap is somehow surprising, considering the trend of fair value recognising

in the past three decades (Barlev & Haddad, 2004) and the considerable study volume on the impact of the fair value measurements on the variables of the capital market.
The research regarding the relevance and credibility of fair value estimations have concluded generally that the fair value measurements based on entry data taken from active markets are more credible compared to those based on information from less active markets or those specific to the entity (AAA FASC, 2005). Although these studies are useful to the accounting normalisers, they do not refer directly to the problems the auditors encounter as they tend to be more preoccupied by the extent in which these evaluations can be verified rather than their relevance. As a consequence we will focus our attention on the formal and practical guidance supplied by the audit standards, but also on the academic research in economy, in relation with the auditing of the fair values.

2. International conceptual notions regarding fair value

The 18th century marks the beginning of the development of the value theory. The classical school was the first to identify the four production factors: earth, capital, work and coordination and it put in debate the relationship between the basic factors which create the value and the supply and demand ratio on the market.
The classical school continued the development of the physiocrats' theses proposing a value theory based in the production cost. A. Smith (1712-1790) considers that value is an objective phenomenon as it is created by combining the capital factor with land and work.
In the practice of enterprise evaluation, the asset-based approach (mainly the use of cost in the assessment of assets in the patrimony of an entity) is built starting from the classic theory of value based on the production cost.
Generally speaking, the management or creation of the value currently imposed as a standard indicator of the performance at microeconomic level and as a universal measure of the pertinence of strategic decisions. (Casta, 2001: 179)
The notion of "fair value" has been used for the first time in the year 1953 by the "Accounting Research" Magazine, in relation with the re-evaluations in the accounting balance.
The concept of fair value becomes more and more popular in an accounting plan by the end of the 20th century. However, it has been present in the specialised literature and accounting regulations of the important European counties and the Anglo-Saxon world three centuries before that. Moreover, some practices of assessment of the unachieved elements or non-discounted at the lowest value between the purchase value and the resale value (market value) goes back to the 14th century. (Casta, 2001: 115)
The concept of fair value has awaken the interest of many theoreticians, practitioners and accounting normalizing authorities who make opinions on defining it.
The fair value, also called "venal value" by some authors, represents the price at which an asset can be exchanged during a balanced transaction. (Tournier, 2000: 39)
Another variant of the previous definition is: the amount for which an asset can be exchanged for in a balanced transaction, between informed and determined parties, other than in a sale forced by liquidation. (Holmes, 2002: 49)
IASB gives the following definition for fair value: The price for the sale of an asset

or the discount of a liability, willingly, between acknowledging parties, within a transaction in which the price is determined objectively (International Accounting Standards Board, 2008).

We can observe the equivalence made between the "fair value" term and the "market value" term. This association is based in the type of asset that required the accounting measurement of another value than the accounting value. This is about financial instruments that offered at any moment a market value through their stock exchange rate, being quoted on the equity market. Later on, there was a need for the extension on all the patrimony elements of the entity in what regards the measurement of their current value.

As considered within professional standard of asset evaluation, even in the conditions of aiming a market value, the fair value obtained this way in accounting purposes can vary from what is understood by licensed evaluators connected permanently at the market conditions through this concept. Hence, there is the case when different conditions than the ones announced by the definition of the market value (according to the measurement standards) can be applied, namely it is possible that there are no conditions that allow the normal ordered sale of the assets or that the hypothetical sale is under a sort of constraint (Champness, 1998, 23). Also, the term "market value", as understood in accounting is used ambiguously in the case of the real estates for which it refers to a market price obtainable on the spot, from the sale of a trading investment, such as the equity dealt on an active market and not in the typical conditions found on the real-estate markets. This type of investments excludes corporate assets (Champness, 1998, 54). The same observation appears in another specialized work, which states that the term real value is usually paired with the one of market value. (Obert, 2004:61)

In order to bring clarifications related to the fair value measurement, FASB (Financial Accounting Standards Board from the USA) decided to release a standard regarding the evaluation at the fair value which will supply a single set of rules to be applied any time when other standards request the use of the fair value. Thus, in September 2006 SFAS n. 157 regarding the "Fair value measurement" was issued.

At national level, we mention Matiş and Mustaţă (2004) who consider that currently and in the near future we will be the witnesses of a mixed evaluation model, characterized both by historical cost and fair values. The economic entities use the historical cost as a measurement value due to tax reasons. The elaboration of two series of accounts (at a historical cost and the fair (market) value) is not justified in all the circumstances if we consider the cost-benefit analysis in the production of the accounting information.

Another argument **pro** fair value is mentioned by the various field specialists, in view of achieving a better comparability regarding the current and future financial performances of the economic entities, as well as the fact that it is advisable to recognize the tangible fixed assets at the fair value.

Other authors believe that the literature existing on the theme of the fair value treats especially the gaps of the accounting systems and practices, especially the traditional ones, based on their historical cost.

We consider that the notion of fair value is wider than the one of "market value" because for the first time we have the possibility to turn to specific techniques in order to determine it.

4. Auditing of the fair value measurements

The synthesis made on the specialized literature includes the important issues referring to the auditors' understanding of the way the fair value measurements are made. These measurements frequently include anticipative information reflected in the market exchange, but also the reasoning regarding the applicability of these entry data taken from the market in the company's specific conditions. The future conditions and events cannot be promptly foreseen; hence, a judgment element is always involved as well. Since more auditors have a poor training in measurement, there is often the need for specialists for the auditing of fair values. Research specialists, as well as those who elaborate policies within an entity can be confronted with the possibility that the structure of the existing audit team is not compatible with the audits that require more and more specialized measurement knowledge (Vera-Munoz et al., 2006).

Except for the lack of knowledge regarding the elaboration of measurements at the fair value that can be felt among the auditors, they can take into account the errors and the tendencies that can influence the reasoning of those who make the measurements. For example, the auditors should take into consideration the fact that in the process of estimating the preparing fair value they might rely too much on the information used to obtain these values (Slovic, 1982; Davies et al., 1994; Paese & Sniezel, 1991; quoted by Martin et al., 2006). As a consequence, the preparers can get in the situation of not taking into consideration other scenarios, relevant information or measurement possibilities.

Also, the previous researches prove that the individually made previsions are featured by inconsistency ad considerable errors. Even if they are used as statistical instruments for the data analysis to facilitate the provisions, the specialised literature suggests the fact that the decision-making individuals can, unconsciously, influence the estimations towards the preferred directions (the references in the specialized literature are Kunda, 1990; Wilks, 2002; Kadous et al., 2003; quoted by Martin et al., 2006).

One of the important issues related to the auditing of the fair values consists in the preoccupation of the auditors regarding the trust in the internal control exerted on the process of fair values measurement. Barlev & Haddad (2004) sustain that this control should be different than the one made during regular transactions. The auditors must make sure that the fair value measurement control activity is made properly especially in what regards the separation of tasks.

On the other hand, the auditors also have to be cautious in what regards the actors that can influence the audit of fair values. For example, the auditors must not only seek evidence that confirms management's assertions, although the current audit guidance specifies this approach. The finding of such evidente is very simple if the auditor only aims that. However, the auditor should also consider the evidence that might invalidate management's assertions. Although no previous research has examined directly this aspect in relation with the audit of the fair value measurements, there are researchers (Koonce, 1992; Kennedy, 1995; Anderson & Koonce, 1998; quoted by Martin et al., 2006) who treated this problem broadly and suggested certain useful steps in avoiding the confirmation bias.

Finally, the auditors must be capable of identifying the suppositions and key entry data in the process of fair value measurement. The lack of guidance in what might represent a significant supposition suggests the fact that the normalisers of the audit activity will have to specify the necessary principles for the identification of

this type of suppositions. The identification of the key suppositions and testing of their reasonable character represents a major preoccupation of the auditors in what regards the fair value measurements.

The SAS 101 audit standard *Auditing Fair Value Measurements and Disclosures* (AU Sec. 328, AICPA 2003) issued by the *American Institute of Chartered Accountants* – AICPA represents a general approach of audit of the fair value and other associated information to be supplied. This standard does not represent a guide for the auditing of patrimony elements in particular (assets, debt or own capital elements reported to the fair value), but they supply a general framework for the auditing of all the fair value measurements.

In the beginning of this standard it is mentioned that the company's management is responsible for the performance of the fair value measurements and the information to supply associated to them included in the financial situations. More precisely, the management must establish the necessary accounting and reporting processes for the determination of the fair value measurements, select the proper evaluation methods, identify and motivate properly any significant presuppositions used, make the evaluations and ensure that their presentation and information to be supplied are according to the generally accepted accounting principles – GAAP.

Many of the fair value measurements result rather from approximations than exact measurements and involve numerous estimations, classifications, arguments and distributions (Public Company Accounting Oversight Board, 2004). The audit of these measurements is made with the purpose to increase their credibility through the reduction of the errors on the valuator or the measurement process (Carmichael, 2004). The direct verification of the accounting measurement by the auditors tends to minimize these errors. However, many fair value measurements are based on measurement techniques (for example, the value of the options on stock granted to the employees) which incorporate entry data that cannot be verified directly and the auditor is forced to act carefully, including to turn to professional scepticism.

We consider as an example the estimations of the fair value for the employee stock option - ESO. These estimations derive directly from a model based on estimated entry data, therefore the auditors must consider whether these estimated entry data – individually and collectively – could be the object of uncertainty of estimation, of the unjustified use or errors. The research suggest that the management uses the admissible action freedom as an opportunity to influence, in the meaning of decreasing, the fair value of these options (Aboody et al., 2006; Balsam et al., 2003; Bartov et al., 2004; quoted by Martin et al., 2006). But more recent results indicate the fact that this freedom might actually improve the predictive accuracy through the transmission by the managers of the private information through estimations (Hodder et al., 2006, quoted by Martin et al., 2006)

Also, we state that all four types of entry data of the model (option's life expectancy, expected volatility of the price of the support action, expected dividends of the equities and the interest rate without risk for the stock's life expectancy) are used systematically to influence the estimations of the fair value for the employee stock options (Balsam et al., 2003; Aboody et al., 2006; Johnston, 2003; citaţi de Martin et al., 2006).

In order to help the auditors, SAS 101 presents a few necessary requirements for the auditing of the measurements at fair values and the information to be supplied associated to them. We consider that these requirements establish two general

challenges for the auditors:
- To understand well enough the entity processes and the relevant control in the determination of the fair values so as to be capable to develop a more efficient audit approach;
- To analyse whether the entity evaluation methods and the significant presumptions are adequate and whether it is likely that they will supply a reasonable basis for the fair value measurement and for the information to be supplied in the financial situations.

Evaluation uncertainty refers to the ambiguity of assessing an element (for example a financial instrument) or the estimation of the discreet number (for example the estimation of the non-retrievable amounts). The nature of the fair values is so complex that it can put in opposition even well intended experts when there is no market for an element or it exists but it is not liquid.

There are two sources for the fair value measurement: marking-to-market and marking-to-model. Both the IFRS 13 International Standard Fair value Measurement and Topic 820 within the Ammerican Accounting Standards establish a hierarchy of fair values based on the entry data used in measurement. According to the hierarchy, the preparers of financial situations must first give priority to the quotations on the active markets for identical assets or liabilities (Level 1) in front of other data than those at level 1 observable directly or indirectly (Level 2). In case there is no level 1 or level 2 data, the preparers will use unnoticeable entry data (Level 3) which reflect the suppositions of the entity about what the participations to the market would use to set the price of an asset or a liability. The subjectivity of the data observable at level 2 and that unobservable at level 3 induce a great uncertainty to the estimation.

The acknowledgement of the verifications made by the USA Public Company Accounting Oversight Board on the audit missions of the companies forming the Big 4 suggest the fact that some of the auditors find it difficult to determine what represents a reasonable insurance in case of fair value measurement with high uncertainty level based on the current audit standards. A few of the deficiencies reported by PCAOB in the 2010 control reports refer to the failure of the auditors to measure the reasonable character of the significant hypothesis made by the management, the excessive trust in the inquiry without confirmation, the failure in testing the indicators regarding the fair value, such as the brokers' quotations and the improper reliance on a test for the determination of the reasonable character which was not accurate enough because the calculated interval allowed the seven times variation of the significance threshold (Bell & Griffin, 2012).

One of the auditors' concern reasons is incorporated even in the audit standards: „The auditor should obtain evidence supporting management's assertions about the fair value of the derivatives and securities measured or disclosed at fair value. (SAS 92, paragraph 35)".

If the auditors followed this instruction they would literally become „victims" of the confirmation tendency because they would only look for evidence that supports management's assertions, not evidence that might invalidate these statements.

The opinion discrepancies related to the nature, duration and extension of the audit procedures in case of high uncertainty fair value measurement are understandable because an inherent uncertainty, although estimable, is irreducible and as a consequence it cannot be decreased or eliminated through auditing. Moreover, there might be a clarity and specificity lack within the current audit standards in

what regards the responsibilities of the auditor in the fair value measurements featured by a high uncertainty since the normalizers or auditors are at the beginning in what regards the experience in auditing new, various and complex assets and liabilities.

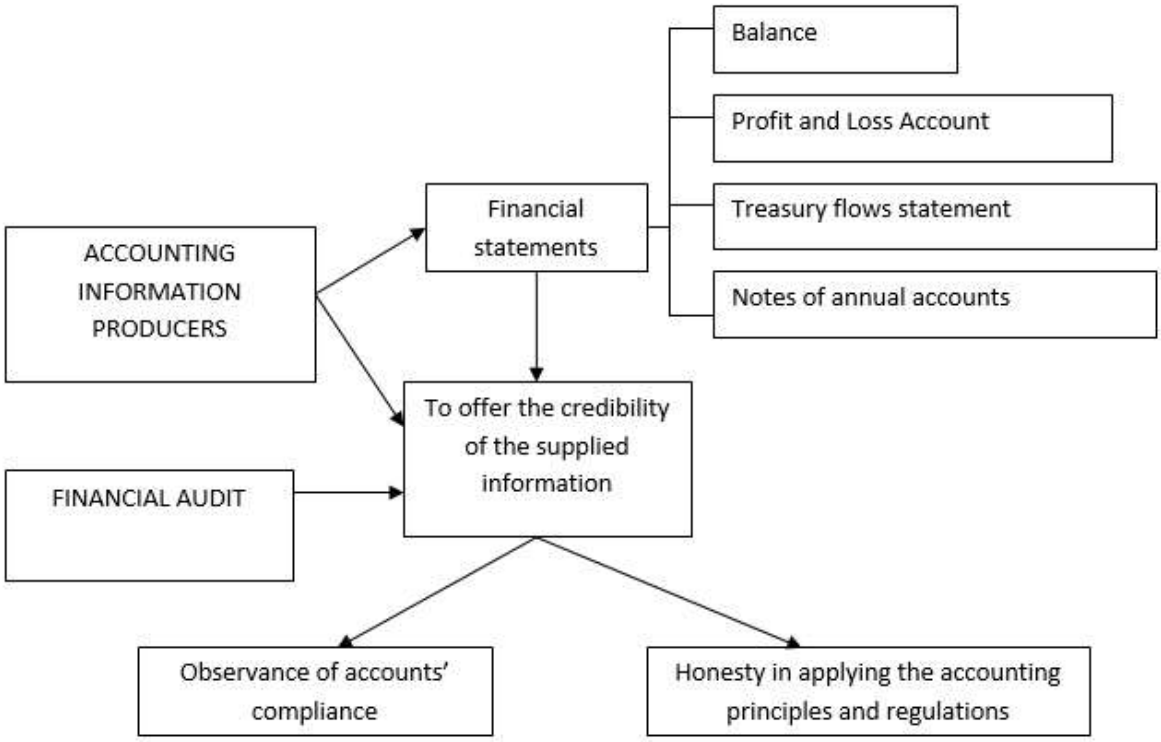

Figure1: .Rolue of financial audit
Source: Own projection

In the analysis of the audit process, the risk evaluation occupies and extremely important place. The evaluation of the audit risk should represent the auditor's main preoccupation. The audit risk could be defined as the risk that an auditor assumes in order to issue an improper audit opinion in what regards the financial situation they audit. The audit standards retain the following definition of the audit risk: "the risk the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated."
For this reason the auditors follow the risks that can appear and that can lead them to opinions that do not reflect reality especially ever since the moment when they accept the audit mission, but also during the mission itself. After the moment of risk identification, the auditors establish the extension of the audit procedures according to the risk areas.
Thee influences and difficulties that might appear in the exertion of the auditor's activity are presented in the following table:

Table 1: Influences and difficulties

Influences	Difficulties
- Anchorage; - Confirmation tendency; - "Overconfidence" + my amount of available information; - The will of not incurring losses; - Excessive optimism; - Extrapolation tendency	- Uncertainties of the external environment; - The control of entity on the fair value; - The complexity of auditing fair values - Potential influences ("motivated reasoning") - Specific evaluation knowledge.

Source: Own projection

In one of his articles, Eugeniu Ţurlea talks about the audit of investments which in his opinion „starts from the assessment of company's performance reflected through the profitability and liquidity indicators, though the analysis of the gross or net profit (taking the sales as a reference basis) and the analysis of the efficiency indicators that reflect the extent to which the efforts made by the company justify the effects generated by its activity. Of course that a pyramid analysis can also be made based on a balance and profit and loss account, without omitting the analysis of the financial risk. […] *the role of financial auditors can be determined in the recommendations of sale-purchase-keeping of the securities and the estimation of the future earnings* (as a base for determination of the price of the securities). As a consequence, the auditor that evaluated the financial-accounting information and the investment decision through the financial analysis used as audit method can motivate the use during a SSIF audit, respectively the audit of the performance in the decision of financial investment and can even create an audit debate group. This group represented by specialists of the capital market, accounting experts and financial analysts must express the point of view based on the audit through the collection of quality audit evidence and through the application of the audit standards, so that the information supplied be useful and indispensable to all investors." (Ţurlea, 2006)

Better quality audits and more detailed audit report will increase confidence in markets, at the same time informing the interested factors about the problems of a certain entity. The direct beneficiaries of the confidence increase are not only the investors and creditors, but also the audited companies (as well as their employees).

5. Conclusions

- The more and more frequent use of the fair values puts the normalizers and practitioners in front of a great challenge, but on the other hand it creates opportunities for the researchers in the audit field;

- The studies should investigate the method and the efficiency of the professional reasoning used by those who make fair value measurements. If this process were understood, auxiliary means could be developed (statistic models) which could help the improvement of the fair value measurement;
- The specialized works draw the attention upon a number of situations the auditors are confronted with in what regards the audit of fair values: The internal control exerted on the fair value measurement process should be different than the one performed during regular transactions, not only the evidence that confirms the management's assertions should be taken into consideration, even if the currrent guidance in what regards audit specifies this approach and the auditors must be capable to identify the suppositions and key entry-data in the process of fair value measurement;
- The fair patrimony measurement which ensured estimation values as close as possible to those possible to be accepted in the case of performing the transactions are based, among others, on pertinent accounting information and, at the same time on the valuator's professional reasoning which can be independent and objective. Thus, the assessment does represent a guarantee in what regards the credibility of the information it offers;
- On its turn, the accounting information that is obtained through a fair measurement acquires extra quality and it contributes significantly to making economic decisions suitable for a good management of the patrimony and entity activity;
- The measurement at the fair value aims a big number of non-financial assets and liabilities; it can be the basis of a new model of accounting representation of the company whose objective will be the one of better transposing the financial situations, the uncertainty that affects the cash-flow provisions and the investment opportunities;
- The fair value of the real estate must reflect the current state of the market and the circumstances existing on the balance and not at a previous or future date;
- The value is created by the interaction of *four independent economic factors:* utility, rarity, will and actual buying capacity;
- An efficient communication between auditor-evaluator-entity as well as an entity that meets the presentation requirements in the financial situations will represent important elements in the investors decision making process;
- The tendency is that the auditor holds relevant knowledge in the measurement process;
- In case a quoted market price is not available, the elaborators must make an estimation of the fair value using the best available information;
- The market determines and sustains the use, the best use determines the market value. The market data lead to a size order of the market value, not to a reasonable estimation.

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