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STAFF AUDIT PRACTICE ALERT NO. 3

AUDIT CONSIDERATIONS IN THE CURRENT ECONOMIC ENVIRONMENT

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Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of PCAOB standards and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Audit Practice Alerts are not rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Recent events in the financial markets and the current economic environment may affect companies' operations and financial reporting and, in turn, may have implications for audits of financial statements and internal control over financial reporting. Audit risks that may have been identified previously may become more significant or new risks may exist due to current events (e.g. those affecting the economy, credit and liquidity). Among other things, the current uncertainties in the market and economy may create questions about the valuation, impairment, or recoverability of certain assets and the completeness or valuation of certain liabilities reflected in financial statements.

The purpose of this staff audit practice alert is to assist auditors in identifying matters related to the current economic environment that might affect audit risk and require additional emphasis. While the alert highlights certain areas, it is not intended to identify all areas that might affect audit risk in the current economic environment or serve as a substitute for the relevant auditing standards. All audits of issuers must be conducted in accordance with the standards of the PCAOB.

The practice alert is organized into six sections –

- Overall audit considerations;
- Auditing fair value measurements;
- Auditing accounting estimates;

- Auditing the adequacy of disclosures;
- Auditor's consideration of a company's ability to continue as a going concern; and
- Additional audit considerations for selected financial reporting areas.

In order to provide guidance to auditors on audit considerations in the current economic environment, this practice alert necessarily describes generally accepted accounting principles ("GAAP") used by public companies in various areas. The Board, however, has no authority to prescribe the form or content of an issuer's financial statements. That authority, and the authority to make binding determinations concerning an issuer's compliance with GAAP, rests with the U.S. Securities and Exchange Commission ("SEC"). Accordingly, while this staff audit practice alert describes applicable GAAP, it should not be understood as establishing or interpreting GAAP.

Overall Audit Considerations

The following section describes overall audit considerations related to planning, fraud, internal controls, substantive procedures, and communications with audit committees that may be affected by recent events in the financial markets and current economic conditions.

Planning considerations

The effects of current economic conditions on a company's operations and financial reporting may affect audit planning. In planning the audit, the auditor should consider, among other things, matters affecting the industry in which the company operates, including the economic conditions.[1/]

As the audit progresses, changed conditions may make it necessary to modify planned audit procedures.[2/] Accordingly, the auditor may need to reassess audit risks and update his or her understanding of how current economic conditions may affect the company's financial reporting. Knowledge of these effects helps the auditor in –

- Identifying areas that may need special consideration;

1/ Paragraphs .03 and .07 of AU sec. 311, *Planning and Supervision,* and paragraph 9 of PCAOB Auditing Standard No. 5 ("AS No. 5"), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

2/ AU sec. 311.05.

- Assessing conditions under which accounting data are produced, processed, reviewed, and accumulated within the company;

- Evaluating the reasonableness of estimates, such as valuation of inventories, depreciation, allowances for doubtful accounts, and percentage of completion of long-term contracts;

- Evaluating the reasonableness of management representations;

- Making judgments about the appropriateness of the accounting principles applied and the adequacy of disclosures.[3/]

Whenever the auditor has concluded that there is significant risk of material misstatement of the financial statements, the auditor should consider this conclusion in determining the nature, timing, or extent of procedures; assigning staff; or requiring appropriate levels of supervision.[4/] Higher risk may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of year end, particularly in critical audit areas, or modify the nature of procedures to obtain more persuasive evidence.[5/]

In an audit of internal control over financial reporting, a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area.[6/]

Fraud risk considerations

The current economic environment may also trigger certain risk factors that may affect the risk of misstatement due to fraudulent financial reporting. Examples of risk factors include –

[3/] AU sec. 311.06.

[4/] Paragraph .17 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*.

[5/] Ibid.

[6/] AS No. 5, paragraph 11.

- Incentives and pressures

    - Financial stability or profitability is threatened by economic, industry, or company operating conditions;

    - Excessive pressure exists for management to meet the requirements or expectations of third parties;

    - Information available indicates management or the board of directors' personal financial situation is threatened by the company's financial performance;

    - Excessive pressure is placed on management or operating personnel to meet financial targets set up by the board of directors or management, including sales or profitability incentive goals;

- Opportunities

    - The nature of the industry or the company's operations provides opportunities to engage in fraudulent financial reporting;

    - There is ineffective monitoring of management;

    - There is a complex or unstable organizational structure;

    - Internal control components are deficient.[7/]

The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[8/] As part of the understanding of internal control sufficient to plan the audit, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation.[9/] Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to

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[7/] Paragraph .85A.2 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[8/] Paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor.*

[9/] AU sec. 316.44.

revenue recognition.[10] The auditor responds to risks of material misstatement due to fraud in the following three ways –

- A response that has an overall effect on how the audit is conducted – that is, a response involving more general considerations apart from the specific procedures otherwise planned.[11] For example, the knowledge, skill, and ability of personnel assigned significant engagement responsibilities should be commensurate with the auditor's assessment of the risks of material misstatement due to fraud for the engagement.[12] The auditor also should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.[13] Further, the auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.[14]

- A response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed.[15] For example, the auditing procedures performed in response to identified risks of material misstatement due to fraud should vary depending upon the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected.[16] Such procedures may involve both substantive tests and tests of the operating effectiveness of the company's programs and controls.[17]

- A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which

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10/ AU sec. 316.41.

11/ AU sec. 316.48.

12/ AU sec. 316.50.

13/ Ibid.

14/ Ibid.

15/ AU sec. 316.48.

16/ AU sec. 316. 51.

17/ Ibid.

such override could occur.[18] For example, the auditor should examine journal entries and other adjustments for evidence of possible material misstatement due to fraud.[19] The auditor also should review accounting estimates for biases that could result in material misstatement due to fraud,[20] and evaluate the business rationale for significant unusual transactions.[21]

The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit.[22]

In an audit of internal control over financial reporting, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error.[23]

Internal control considerations

The current environment may increase audit risk and thus require additional auditor attention regarding the effective operation of internal controls. Areas in which additional attention may be required include the company's entity-level controls, such as, among other things, controls related to the control environment, and the company's risk assessment process. Additional attention also may be warranted on the controls related to certain significant accounts and disclosures and their relevant assertions, such as controls over the development of inputs and assumptions for the valuation of significant assets and liabilities; controls over the identification and review of assets for recoverability or impairment; and controls over the company's use of external specialists (for example, valuation or actuarial specialists) who assist in the determination of recorded amounts of certain assets or liabilities. In addition, some companies are responding to the current economic conditions by eliminating jobs. The loss of employees integral to the operation of internal controls may increase the risk of deficiencies in internal control over financial reporting because of, for example, lack of segregation of duties or lack of effective monitoring controls.

18/ AU sec. 316.48.

19/ AU sec. 316.58.

20/ AU sec. 316.63.

21/ AU sec. 316.66.

22/ AU sec. 316.68.

23/ AS No. 5, paragraph 11.

In an audit of internal control over financial reporting, the auditor also should evaluate whether the company's controls sufficiently address the identified risks of material misstatement due to fraud[24/] and controls intended to address the risk of management override of controls.[25/] Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.[26/]

Effect on substantive procedures

Because the current environment may increase inherent and control risks, the auditor might need to modify his or her planned substantive procedures or perform additional substantive procedures in order to reduce the level of detection risk to an acceptable level to support his or her opinion on the financial statements. Examples of modifications of planned substantive procedure include the following –

- Changing the nature of substantive tests from a less effective to a more effective procedure, such as using tests directed toward independent parties outside the company rather than tests directed toward parties or documentation within the company;
- Changing the timing of substantive tests, such as performing them at year end rather than at an interim date; and

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[24/] AS No. 5, paragraph 14.

[25/] AS No. 5, paragraph 14. AU secs. 316.57 to .67 describe procedures that should be performed to address the risk of management override of controls.

[26/] AS No. 5, paragraph 14.

- Changing the extent of substantive tests, such as using a larger sample size.[27/]

Communications with audit committees

The auditor has a responsibility to communicate certain matters related to the conduct of the audit to the audit committee.[28/] Some of the required communications that may be affected by current economic conditions include discussions about accounting estimates as well as the company's accounting principles.

With respect to accounting estimates, the auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.[29/] The auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting.[30/] The discussion should include such matters as the consistency of the company's accounting policies and their application, and the clarity and completeness of the company's financial statements, which include related disclosures.[31/] The discussion also should include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[32/] Examples of items that may have such an effect include the following –

- Selection of new or changes to accounting policies;
- Estimates, judgments, and uncertainties;
- Unusual transactions; and

27/ Paragraph .82 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.

28/ Paragraph .01 of AU sec. 380, *Communication With Audit Committees.*

29/ AU sec. 380.08.

30/ AU sec. 380.11.

31/ Ibid.

32/ Ibid.

- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded.[33/]

While these and other communications are directed to the audit committee, the auditor is not precluded from communicating with management or other individuals within the company, who may, in the auditor's judgment, benefit from the communications.[34/]

Auditing Fair Value Measurements

Certain kinds of investments such as auction rate securities, commercial paper, mortgage-backed or other asset-backed securities, alternative investments (such as hedge funds, private equity investments, funds of funds, etc.), collateralized debt obligations and other investments may present complexities in valuation because of the current conditions in the financial markets. Accordingly, difficulties surrounding the measurement of fair value and the adequacy of related disclosures have come under increased focus over the past year.

Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurements*,[35/] establishes a framework for measuring fair values for financial reporting purposes and expands disclosures about those measurements. On September 30, 2008, the SEC's Office of the Chief Accountant and the Financial Accounting Standards Board ("FASB") staff issued *Clarifications on Fair Value Accounting* acknowledging that "the current environment has made questions surrounding the determination of fair value particularly challenging for preparers, auditors and users of financial information."[36/] On October 10, 2008, the FASB issued Staff Position ("FSP") No. FAS 157-3, *Determining the Fair Value of a Financial Asset*

[33/] Ibid.

[34/] AU sec. 380.02.

[35/] In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 157, *Fair Value Measurements*, which is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The FASB deferred the implementation of SFAS No. 157 for certain nonrecurring, nonfinancial assets and liabilities for financial statements issued for fiscal years beginning after November 15, 2008 and interim periods within those fiscal years.

[36/] See http://www.sec.gov/news/press/2008/2008-234.htm.

When the Market for That Asset Is Not Active, which provides application guidance regarding –

- How the company's own assumptions (that is, expected cash flows and appropriately risk-adjusted discount rates) should be considered when measuring fair value when relevant observable inputs do not exist;

- How available observable inputs in a market that is not active should be considered when measuring fair value; and

- How the use of market quotes (for example, broker quotes or pricing services for the same or similar financial assets) should be considered when assessing the relevance of observable and unobservable inputs available to measure fair value.[37/]

The following matters may be particularly important for auditors in considering fair value accounting estimates –

- The extent to which fair value accounting applies to various accounts;

- The choice and complexity of valuation techniques and models;

- Judgments concerning significant assumptions that may be used by others such as specialists employed or engaged by the company or the auditor;

- The availability, or lack thereof, of information or evidence and its reliability; and

- The extent of disclosure in the financial statements about measurement methods and uncertainty.

PCAOB Staff Audit Practice Alert No. 2 ("Practice Alert No. 2"), *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists*, remains relevant in the current environment and reminds auditors of their responsibilities with regard to –

- Auditing fair value measurements,

- Classification within the fair value hierarchy under SFAS 157,

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[37/] Paragraph 5 of FASB Staff Position ("FSP") No. FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*.

- Using the work of specialists, and
- Use of a pricing service.[38/]

In discussing the auditor's responsibilities for auditing fair value measurements, Practice Alert No. 2 refers the auditor to AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

Auditing Accounting Estimates

Accounting estimates measure the effects of past business transactions or events, or the present status of an asset or liability.[39/] Examples of accounting estimates include net realizable value of inventories, allowance for uncollectible accounts receivable, valuation allowance for deferred tax assets, actuarial assumptions in pension and other postretirement benefit costs, the impairment analysis and estimated useful lives of long-lived assets, restructuring accruals, and assumptions used in option-pricing models for share-based payments.[40/] In auditing accounting estimates, the auditor normally should consider, among other things, the company's historical experience in making past estimates as well as the auditor's experience in the industry.[41/] However, changes in facts, circumstances, or a company's procedures may cause factors different from those considered in the past to become significant to the accounting estimate.[42/] The significance of the recent changes in the economy and the financial markets increases the likelihood that this will be the case.

The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole.[43/] In evaluating the reasonableness of accounting estimates, the auditor should

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38/ PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (December 10, 2007).

39/ Paragraph .02 of AU sec. 342, *Auditing Accounting Estimates*.

40/ See AU sec. 342.16 for other examples of accounting estimates.

41/ AU sec. 342.09.

42/ Ibid.

43/ AU sec. 342.04.

obtain an understanding of how management developed the estimate.[44/] Based on that understanding, the auditor should use one or a combination of the following approaches–

- Review and test the process used by management to develop the estimate;

- Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate;

- Review subsequent events or transactions occurring prior to the date of the auditor's report.[45/]

The work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.[46/]

In evaluating the reasonableness of an estimate, the auditor normally concentrates on key factors and assumptions that are –

- Significant to the accounting estimate;

- Sensitive to variations;

- Deviations from historical patterns;

- Subjective and susceptible to misstatement and bias.[47/]

When assessing audit differences between estimates best supported by the audit evidence and the estimates included in the financial statements, the auditor should consider whether such differences, even if they are individually reasonable, indicate a

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44/ AU sec. 342.10.

45/ Ibid.

46/ Ibid.

47/ AU sec. 342.09.

possible bias on the part of the company's management, in which case the auditor should reconsider the estimates taken as a whole.[48/]

As part of the audit, the auditor also should perform a retrospective review of significant accounting estimates reflected in the financial statements of the prior year to determine whether management judgments and assumptions relating to the estimates indicate a possible bias on the part of management.[49/] With the benefit of hindsight, a retrospective review should provide the auditor with additional information about whether there may be a possible bias on the part of management in making the current-year estimates.[50/]

Auditing the Adequacy of Disclosures

The current economic environment may increase the risks regarding the adequacy of disclosures, including the disclosures surrounding a company's risks and uncertainties, which in turn may warrant additional auditor attention.

The American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties*, focuses on disclosures about risks and uncertainties, that in the near term (considered to be within one year from the date of the financial statements), could affect the amounts reported in the financial statements or the functioning of the reporting company.[51/] SOP 94-6 provides that companies should make disclosures in their financial statements about the risks and uncertainties in the following areas –

- Nature of operations;
- Use of estimates in the preparation of financial statements;
- Certain significant estimates;

48/ AU sec. 316.63.

49/ AU sec. 316.64.

50/ Ibid.

51/ Paragraph .02 of American Institute of Certified Public Accountants' Statement of Position 94-6 ("SOP 94-6"), *Disclosure of Certain Significant Risks and Uncertainties.* Paragraph .07 of SOP 94-6 defines near term as a period of time not to exceed one year from the date of the financial statements.

- Current vulnerability due to certain concentrations.[52/]

The presentation of financial statements in conformity with GAAP includes adequate disclosure of material matters, related to the form, arrangement, and content of the financial statements and their appended notes.[53/] The auditor considers whether a particular matter should be disclosed in light of the circumstances and facts of which he or she is aware at the time.[54/] If management omits from the financial statements, including the accompanying notes, information that is required by GAAP, the auditor should express a qualified or adverse opinion and should provide the information in his or her report, if practicable, unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB auditing standard.[55/]

With respect to other information included in documents containing the financial statements, the auditor should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[56/] For instance, the section on management's discussion and analysis of financial condition and results of operations in Form 10-K requires discussion of liquidity, capital resources, results of operations, off-balance sheet arrangements and contractual obligations.[57/] In addition, the section on controls and procedures of the Form 10-K requires discussion of management's responsibility for internal control over financial reporting and changes in internal control over financial reporting.[58/] If the information in these disclosures is materially inconsistent with the financial statements, the auditor should determine whether the financial statements, the audit report, or both require revision.[59/]

[52/] SOP 94-6, paragraph .08.

[53/] Paragraph .02 of AU sec. 431, *Adequacy of Disclosure in Financial Statements*.

[54/] Ibid.

[55/] AU sec. 431.03.

[56/] Paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

[57/] Regulation S-K, Item 303, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

[58/] Regulation S-K, Items 308 and 308T, *Internal Control Over Financial Reporting*.

[59/] AU sec. 550.04.

Auditor's Consideration of a Company's Ability to Continue as a Going Concern

In the current economic environment, some companies may face challenges in their ability to continue operating as a going concern. For instance, sources of liquidity may be strained because of reduced availability of lines/letters of credit from financial institutions or because of a violation of a debt covenant or other covenant. Additionally, companies may encounter limited access to the commercial paper markets, a decrease in valuation of collateral, difficulty restructuring loans, and delays in payment from customers.

The auditor has a responsibility to evaluate whether there is a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.[60/] The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.[61/]

The auditor's evaluation includes considering whether the results obtained in planning, performing, and completing the audit identify conditions and events that, when considered in the aggregate, indicate there could be a substantial doubt about the company's ability to continue as a going concern for a reasonable period of time.[62/] It may be necessary to obtain additional information about such conditions and events, as well as the appropriate evidential matter to support information that mitigates the auditor's doubt.[63/] Conditions or events that, when considered in the aggregate, indicate there could be substantial doubt about the company's ability to continue as a going concern for a reasonable period of time include –

- *Negative trends* – for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, adverse key financial ratios;

- *Other indications of possible financial difficulties* – for example, default on loan or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, noncompliance with statutory

60/ Paragraph .02 of AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern.*

61/ Ibid.

62/ AU sec. 341.03a.

63/ Ibid.

capital requirements, need to seek new sources or methods of financing or to dispose of substantial assets;

- *Internal matters* – for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations;

- *External matters that have occurred* – for example, legal proceedings, legislation, or similar matters that might jeopardize a company's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; uninsured or underinsured catastrophe such as a drought, earthquake, or flood.[64/]

If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the auditor should obtain information about management's plans that are intended to mitigate the effect of such conditions or events, and assess the likelihood that such plans can be effectively implemented.[65/] The auditor's considerations relating to management plans may include the following –

- Plans to dispose of assets;

- Plans to borrow money or restructure debt;

- Plans to reduce or delay expenditures;

- Plans to increase ownership equity.[66/]

Such considerations also may include the effect of federal assistance or participation in a federal program.

If, after considering identified conditions and events and management's plans, the auditor concludes there is substantial doubt, he or she should consider the possible effects on the financial statements and the adequacy of disclosure about the company's inability to continue as a going concern for a reasonable period of time, and include an

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[64/] AU sec. 341.06.

[65/] AU sec. 341.03b.

[66/] AU sec. 341.07.

explanatory paragraph in the audit report to reflect this conclusion.[67/] If the auditor concludes that substantial doubt is alleviated, the auditor should consider the need for disclosure of the principal conditions and events that initially caused the auditor to believe there was substantial doubt.[68/]

Additional Audit Considerations for Selected Financial Reporting Areas

The following discussion provides auditors with information on selected financial reporting areas that may be affected by the current economic environment. The auditor should give consideration to elevated risks related to the current economic environment and adjust his or her audit procedures as appropriate. This list is not intended to be all-inclusive.

- Consolidation
- Contingencies and guarantees
- Credit derivatives
- Debt obligations
- Deferred tax assets
- Derivatives (other than credit derivatives)
- Goodwill, intangible assets and other long-lived assets
- Inventory
- Other-than-temporary impairment
- Pension and other postretirement benefits
- Receivables

67/ AU secs. 341.10 and 341.12.

68/ AU sec. 341.11.

- Restructuring
- Revenue recognition
- Share-based payments

Consolidation

As a result of the economic environment, some companies have provided financial support or guarantees, or have taken other actions that may cause them to have a variable interest in an entity or to have increased their exposure to the entity, and, therefore, cause them to consider or reconsider whether the entity is a variable interest entity and if so whether they are its primary beneficiary.[69] Such commitments to provide financial support or guarantees might be found in various contractual arrangements, such as leasing arrangements, supply contracts, service contracts or derivative contracts.

FASB Interpretation ("FIN") No. 46(R) (as amended), *Consolidation of Variable Interest Entities – an interpretation of ARB No. 51*, addresses consolidation by the primary beneficiary of variable interest entities. On November 21, 2008, the FASB announced plans to issue final FSP FAS 140-4 and FIN 46(R)-8, *Disclosures about Transfers of Financial Assets and Interests in Variable Interest Entities,* by December 15, 2008, which will increase disclosure requirements for public companies for reporting periods that end after December 15, 2008.[70]

Contingencies and guarantees

Recent events in the credit markets may expose companies to additional contingencies and guarantees, which could increase the risk of unidentified or undisclosed contingencies related to, for example –

- Pending or threatened litigation;
- Asserted or unasserted claims and assessments;
- Guarantees of indebtedness of others;

[69] Paragraphs 7 and 15 of FASB Interpretation ("FIN") No. 46(R) (as amended), *Consolidation of Variable Interest Entities – an interpretation of ARB No. 51*.

[70] See http://www.fasb.org/news/nr112108.shtml.

- Guarantees to repurchase receivables or property previously sold or otherwise assigned;

- Violations of laws and regulations;

- Guarantees of contractual performance of others; and

- Outstanding purchase commitments at prices in excess of market values.

The audit normally includes procedures that might identify litigation, claims, and assessments, among other things.[71/] Examples of such procedures include the following–

- Reading minutes of meetings of stockholders, directors, and appropriate committees held during and subsequent to the period being audited;

- Reading contracts, loan agreements, leases, and correspondence from taxing or other governmental agencies, and similar documents;

- Obtaining information concerning guarantees from bank confirmation forms;

- Inspecting other documents for possible guarantees by the client.[72/]

Credit derivatives

The downturn in the credit markets can have a significant effect on the fair value of a company's credit derivatives. A credit derivative is a derivative instrument whose value derives from the credit risk on an underlying bond, loan or financial asset. The

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[71/] Paragraph .07 of AU sec. 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims and Assessments*. AU sec. 337.08 indicates that a letter of audit inquiry to the client's lawyer is the auditor's primary means of obtaining corroboration of the information furnished by management concerning litigation, claims, and assessments.

[72/] AU sec. 337.07.

credit risk is on an entity other than the counterparty to the transaction.[73/] This entity is known as a reference entity, which incurred the debt.[74/]

Credit derivatives are bilateral contracts between the buyer and seller under which the seller sells to the buyer protection against the credit risk of the reference entity.[75/] Credit derivatives may be valued through the use of internally developed models or by pricing services. The assumptions used in models can be highly subjective, sensitive, and complex. A slight difference in assumptions could result in a significant change in the valuation of the derivative.

One factor that affects the fair value of credit derivatives is a decline in the credit quality of the reference entity. As a result of the deterioration in credit derivative positions insured by sellers of credit derivatives, some sellers have been required to post significant amounts of additional collateral. A seller also may be required to post additional collateral based on the deterioration of its own credit standing (regardless of changes in value of the written credit derivatives) to protect the buyer from default by the seller. In addition, the fair value of the asset included in the buyer's financial statements is affected by both the credit rating of the seller of the credit derivative (the counterparty) and the credit rating of the reference entity. The credit risk of the seller may affect the fair value of the liability in the seller's financial statements. In response to concerns from financial statement users and others that the current disclosure requirements for derivative instruments and certain guarantees did not adequately address the potential adverse effects of changes in the credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives and certain guarantees, the FASB issued a staff position aimed at improving such disclosures.[76/]

73/ Satyajit Das, *Credit Derivatives: CDOs and Structured Credit Products*, (Singapore: John Wiley and Sons (Asia) Pte Ltd, 2005, Third Edition).

74/ Edmund Parker, "Credit Derivatives," *PLC Finance* (http://www.mayerbrown.com/london/article.asp?id=4234&nid=1575).

75/ Ibid.

76/ Paragraph 1 of FSP No. FAS 133-1 and FIN 45-4, *Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161* (September 12, 2008).

The auditor should obtain evidence supporting management's assertions about the fair value of derivatives measured or disclosed at fair value.[77/] In addition, the auditor should evaluate whether the presentation and disclosure of derivatives are in conformity with GAAP.[78/]

In addition to valuation and presentation and disclosure, other considerations relate to existence and completeness. In March 2008, the President's Working Group on Financial Markets noted "[w]hile the infrastructure of the financial markets generally has coped quite well with heightened price volatility and surging trading volumes, there have been issues with the accuracy and timeliness of trade data transmissions, the timeliness of resolutions of trade matching errors, documentation and cash settlement, electronic post-trade processing, backlogs, integrated processing, and reconciliation and valuation."[79/] Sellers and buyers of credit derivatives may have made trades which may not be properly reflected in the financial statements. AU sec. 332 provides examples of substantive procedures auditors may perform to obtain evidence about whether all derivatives have been properly identified and appropriately included in the financial statements.[80/]

Debt obligations

Companies may find it more difficult to refinance debt or it may take longer to arrange new financing in the current business environment, and compliance with debt covenants may be more challenging. Circumstances such as the following can affect

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77/ Paragraph .35 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*. AU secs. 332.35 to .48 provide further direction on auditing valuations based on fair value.

78/ AU sec. 332.49. AU secs. 332.49 to .51 provide further direction on auditing presentation and disclosure of derivatives.

79/ See pages 18 to 19 of the Policy Statement on Financial Market Developments by The President's Working Group on Financial Markets (March 2008) (http://www.treas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf). In June 2008, the Federal Reserve Bank of New York noted that "[s]tarting in September 2005, industry participants implemented a number of initiatives to improve the operational performance and infrastructure of the over-the-counter markets" and that market participants and regulators agreed on an "agenda for bringing about further improvements in the OTC derivatives market infrastructure." Federal Reserve Bank of New York, "Statement Regarding June 9 Meeting on Over-the-Counter Derivatives" (June 9, 2008), (http://www.newyorkfed.org/newsevents/news/markets/2008/ma080609.html).

80/ AU secs. 332.21 to .24.

the risks of material misstatement and the necessary audit procedures regarding debt obligations –

- Violations of existing debt covenants;
- Proper classification between short-term and long-term debt;
- The existence of cross default provisions, such that a violation of a covenant on one loan affects compliance with covenants for another loan;
- Exchange of debt or modifications to the terms of outstanding debt agreements;
- Concessions granted by lenders, including those that constitute a troubled debt restructuring;
- Subjective acceleration clauses;
- Embedded derivatives.

Deferred tax assets

Under current economic conditions, companies may need to record valuation allowances for their deferred tax assets. Deferred tax assets are required to be reduced "by a valuation allowance if, based on the weight of available evidence, it is *more likely than not* (a likelihood of more than 50 percent) that some portion or all of the deferred tax assets will not be realized." [81/]

Evaluating the need for and amount of a valuation allowance for deferred tax assets requires consideration of "all available evidence, both positive and negative"[82/] to determine whether all or some portion of the deferred tax assets will not be realized. SFAS No. 109, *Accounting for Income Taxes*, provides that the more negative evidence that exists (a) the more positive evidence is necessary and (b) the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset.[83/]

[81/] Paragraph 17e of SFAS No. 109 (as amended), *Accounting for Income Taxes*.

[82/] SFAS No. 109, paragraph 20.

[83/] SFAS No. 109, paragraph 25.

In addition, SFAS No. 109 states that "information about an enterprise's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required."[84/]

Future realization of a deferred tax asset "ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law."[85/] SFAS No. 109 states that "the weight given to the potential effect of negative and positive evidence should be commensurate with the extent to which it can be objectively verified."[86/]

In addition, FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*, defines a criterion that an individual tax position must meet for any part of the benefit of that position to be recognized in a company's financial statements.[87/] The interpretation also provides guidance on measurement, derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.[88/]

Derivatives (other than credit derivatives)

The current environment may have a significant effect on the fair value of a company's derivative contracts. In addition, the ability for a company to use hedge accounting, including its ability to apply the short-cut method, may be affected because of the company's or the counterparty's creditworthiness.[89/] Hedge accounting also may

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84/ SFAS No. 109, paragraph 20.

85/ SFAS No.109, paragraph 21.

86/ SFAS No.109, paragraph 25.

87/ Paragraph 2 of FIN No. 48 (as amended), *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*.

88/ Ibid.

89/ FASB Staff Implementation Guidance: Guide to Implementation of Statement 133 on Accounting for Derivative Instruments and Hedging Activities, Issue G10 ("DIG Issue G10"), *Cash Flow Hedges: Need to Consider Possibility of Default by the Counterparty to the Hedging Derivative.*

be affected because changes in the fair value of the derivative may be attributable to a risk other than the risk that is being hedged, such as company or counterparty creditworthiness.[90/]

Auditors should obtain evidence supporting management's assertion about the fair value of derivatives measured or disclosed at fair value.[91/] External factors, such as credit and market risk, may affect the valuation of derivatives. Credit or default risk exposes the company to the risk of loss as a result of the counterparty to a derivative failing to meet its obligation. Alternatively, the credit risk of the company may affect the fair value of the derivative when the derivative is in a liability position. Market risk exposes the company to the risk of loss from adverse changes in market factors that affect the fair value of a derivative, such as interest rates and foreign exchange rates.

In order for a company to use hedge accounting, GAAP requires that management have an expectation that the hedging relationship will be highly effective at inception and on an ongoing basis.[92/] Counterparty default risk may affect hedge accounting as GAAP requires that consideration be given to the likelihood that the counterparty will comply with the contractual terms of the derivative contract.[93/] If the likelihood that the counterparty will not default ceases to be probable, the company would be unable to conclude that a cash flow hedging relationship is expected to be highly effective in achieving offsetting cash flows.[94/] Additionally, a change in the creditworthiness of the derivative's counterparty in a fair value hedge would affect the assessment of whether the relationship qualifies for hedge accounting and amount of ineffectiveness recognized in earnings under fair value hedge accounting.[95/] Under SFAS No. 133, hedge accounting ceases when a hedge is no longer highly effective on an ongoing basis.[96/]

[90/] Paragraphs 20 and 28 of SFAS No. 133 (as amended), *Accounting for Derivative Instruments and Hedging Activities*, discuss the risks that are being hedged for a fair value and a cash flow hedge, respectively. Paragraphs 25 and 29 of SFAS No. 133 indicate when to discontinue hedge accounting for a fair value and cash flow hedge, respectively.

[91/] AU sec. 332.35.

[92/] SFAS No. 133, paragraphs 20b and 28b.

[93/] DIG Issue G10.

[94/] Ibid.

[95/] Ibid.

[96/] SFAS No. 133, paragraph 67.

When assessing hedge accounting, auditors should gather evidential matter –

- To determine whether management complied with the hedge accounting requirements of GAAP, including designation and documentation requirements.[97/]

- To support management's expectation at the inception of the hedge that the hedging relationship will be highly effective and its periodic assessment of the ongoing effectiveness of the hedging relationship as required by GAAP.[98/]

- Supporting the recorded change, for a fair value hedge, in the hedged item's fair value that is attributable to the hedged risk.[99/]

In addition, for a cash flow hedge of a forecasted transaction, the auditor should evaluate management's determination of whether a forecasted transaction is probable.[100/]

Goodwill, intangible assets and other long-lived assets

Market conditions during an economic downturn may result in an impairment of goodwill, other indefinite-lived intangible assets and other long-lived assets. Goodwill and indefinite-lived intangible assets "shall be tested for impairment annually, or more frequently if events or changes in circumstances indicate that the asset might be impaired."[101/] Similarly, SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets*, states that "A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable."[102/] The following are examples of such events and changes in circumstances –

97/ AU sec. 332.53.

98/ Ibid.

99/ AU sec. 332.54.

100/ AU sec. 332.55.

101/ Paragraph 17 of SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets.*

102/ Paragraph 8 of SFAS No. 144 (as amended), *Accounting for the Impairment or Disposal of Long-Lived Assets*.

- A significant decrease in the market price of a long-lived asset (asset group);
- A significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition;
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator;
- An accumulation of costs significantly in excess of the amount originally expected for the acquisition or construction of a long-lived asset (asset group);
- A current-period operating or cash flow loss combined with a history of operating or cash flow losses or a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group);
- A current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life. The term more likely than not refers to a level of likelihood that is more than 50 percent.[103/]

Goodwill of a reporting unit shall be tested for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount.[104/] Examples of such events or circumstances include –

- A significant adverse change in legal factors or in the business climate;
- An adverse action or assessment by a regulator;
- Unanticipated competition;
- A loss of key personnel;

103/ Ibid.

104/ SFAS No. 142, paragraph 28.

- A more-likely-than-not expectation that a reporting unit or a significant portion of a reporting unit will be sold or otherwise disposed of;

- The testing for recoverability under SFAS No. 144 of a significant asset group within a reporting unit;

- Recognition of a goodwill impairment loss in the financial statements of a subsidiary that is a component of a reporting unit.[105/]

In addition to valuation, companies may need to reassess the useful life of indefinite-lived intangible assets and other long-lived assets. SFAS No. 142 (as amended), *Goodwill and Other Intangible Assets,* requires companies to "evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life."[106/] In addition, when other long-lived assets (asset group) are tested for recoverability, companies also may need to review depreciation estimates and methods.[107/] Under SFAS No. 144, any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability.[108/]

Inventory

Current market conditions and the effect on consumer spending may result in excess or obsolete inventory or inventory with carrying amounts in excess of market values. Inventory is required to be stated at the lower of cost or market.[109/] The following are examples of conditions related to the current environment that might affect the risk of material misstatement of inventory valuation and the necessary audit procedures –

- An increase in inventory balances in relation to sales levels, a reduction in inventory turnover, and the aging of inventory may indicate excess or obsolete inventory balances that are not recoverable.

[105/] Ibid.

[106/] SFAS No. 142, paragraph 16.

[107/] SFAS No. 144, paragraph 9.

[108/] Ibid.

[109/] Accounting Research Bulletin ("ARB") No. 43 (as amended), *Inventory Pricing*, chapter 4.

- Declining prices may indicate the carrying amount of inventory is in excess of market value. Accounting Research Bulletin ("ARB") No. 43 (as amended), *Inventory Pricing* (chapter 4), requires that a loss be recognized in the current period "whenever the utility of goods is impaired by damage, deterioration, obsolescence, changes in price levels, or other causes."[110/]

In addition, losses on firm, uncancelable, and unhedged commitments to purchase inventory should be measured in the same way as are inventory losses and, if material, should be recognized in the accounts in the current period and separately disclosed in the income statement.[111/]

Other-than-temporary impairment

Many debt and equity securities have experienced significant declines in fair value. These declines in fair value may raise questions about whether such declines are other than temporary. The auditor should evaluate management's conclusion about the need to recognize in earnings an impairment loss for a decline in fair value that is other than temporary.[112/]

In accordance with SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities*, a charge to earnings should be made for impairment that is "other than temporary" in held-to-maturity and available-for-sale securities.[113/] SEC Staff Accounting Bulletin ("SAB") No. 59, *Accounting for Noncurrent Marketable Equity Securities*, also provides the SEC staff's view and indicates that "other than temporary" should not be interpreted to mean "permanent." SAB No. 59 provides examples of factors which, individually or in combinations, may indicate that a decline is other than temporary and that a write-down of the carrying value is required, including –

- The length of the time and the extent to which the market value has been less than cost;

[110/] ARB No. 43, chapter 4, paragraph 8.

[111/] ARB No. 43, chapter 4, paragraph 17.

[112/] AU sec. 332.46.

[113/] Paragraph 16 of SFAS No. 115 (as amended), *Accounting for Certain Investments in Debt and Equity Securities.*

- The financial condition and near-term prospects of the issuer, including any specific events which may influence the operations of the issuer such as changes in technology that may impair the earnings potential of the investment or the discontinuance of a segment of the business that may affect the future earnings potential; or

- The intent and ability of the holder to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value.

SAB No. 59 further provides that "[u]nless evidence exists to support a realizable value equal to or greater than the carrying value of the investment, a write-down accounted for as a realized loss should be recorded."

Additionally, under FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets,* certain beneficial interests should be written down to fair value through earnings if the security has declined below its cost and there has been an adverse change in the estimated cash flows based on a holder's best estimate of cash flows that a market participant would use in determining the fair value of the beneficial interest.[114/]

Pension and other postretirement benefits ("OPEB")

Increased credit risk and reduced liquidity in the current economic environment can have a significant effect on the fair value of plan assets as well as the assumptions used to measure the pension and OPEB obligation. Companies that sponsor pension and OPEB plans are required to recognize the funded status of these plans in the statement of financial position.[115/] The funded status is measured as the difference between the fair value of plan assets and the benefit obligation.[116/] SFAS No. 87 (as amended), *Employers' Accounting for Pensions*, and SFAS No. 106 (as amended), *Employers' Accounting for Postretirement Benefits Other Than Pensions*, generally require that plan investments, whether equity or debt securities, real estate or other, be

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[114/] Paragraph 12b of FASB Emerging Issues Task Force No. 99-20, *Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets.*

[115/] Paragraph 1 of SFAS No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 88, 106, and 132(R)*.

[116/] SFAS No. 158, paragraph 4a.

measured at fair value as of the measurement date.[117] Therefore, the measurement requirements of SFAS No. 157 apply to defined-benefit postretirement plan assets.

Several assumptions are relevant to determining a company's pension and OPEB obligation, such as discount rate, expected rate of return on plan assets, and rate of compensation increase. Significant declines in the stock market may adversely affect the fair value of the plan assets, and companies may need to consider recent shifts in the market when developing the expected rate of return on plan assets. Changes in fair value of plan assets affect the funded status of the plan.[118] Deviations from the expected rate of return on plan assets affect a company's pension or OPEB expenses in future periods,[119] unless gains and losses are recognized immediately.[120]

Receivables

In the current economic environment, companies may face a heightened risk of non-collection of receivables. Evidence of this risk might be noted in an increase in days sales outstanding, the aging of receivables, or the amount of delinquent receivables.[121] In addition for loans receivable, evidence of this risk might be rising loan delinquency and defaults and decreasing secondary market liquidity.[122] These situations can affect the risk of material misstatement in the valuation of a company's receivables and the auditor's evaluation of management's estimate of the allowance.

117/ Paragraph 49 of SFAS No. 87 (as amended), *Employers' Accounting for Pensions* and paragraph 65 of SFAS No. 106 (as amended), *Employers' Accounting for Postretirement Benefits Other Than Pensions*.

118/ SFAS No. 87, paragraph 35 and SFAS No. 106, paragraph 44A.

119/ SFAS No. 87, paragraph 34 and SFAS No. 106, paragraph 62.

120/ SFAS No. 87, paragraph 32 and SFAS No. 106, paragraph 59.

121/ Scott Malone, “Corporate America Taking Longer to Collect: Study" (August 24, 2008), (http://www.reuters.com/article/reutersEdge/idUSN2745047620080827), noted that it is taking companies longer to collect from their customers .

122/ SFAS No. 114 (as amended), *Accounting by Creditors for Impairment of a Loan- an amendment of FASB Statements no. 5 and 15*, addresses the accounting by creditors for impairment of a loan by specifying how allowances for credit losses related to certain loans should be determined.

Restructuring

Market events and their effect on liquidity have caused many companies to take actions such as restructuring to reduce costs. SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities*, addresses financial accounting and reporting for costs associated with exit or disposal activities.[123/] The risks of material misstatement may relate to recording costs in the improper period, incorrect measurement or presentation of restructuring liabilities and costs, or inadequate disclosures. Misstatements could result in understatement or overstatement of restructuring liabilities and costs.

Revenue recognition

In the current economic environment, companies may be faced with increased pressure to meet revenue targets and analysts' expectations. These pressures may cause companies to change business practices, which could affect the amount and timing of revenue recognition. Examples of business practices that could affect revenue recognition and the necessary audit procedures include, among other things, rights of return, bill-and-hold arrangements, change in payment terms, side agreements, and consignment arrangements. Also, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition.[124/]

[123/] As described in paragraph 2a of SFAS No. 146 (as amended), *Accounting for Costs Associated with Exit or Disposal Activities,* SFAS No. 146 does not change the accounting for termination benefits, including one-time termination benefits granted in the form of an enhancement to an ongoing benefit arrangement, covered by SFAS No. 87, SFAS No. 88 (as amended), *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, SFAS No. 106, and SFAS No. 112 (as amended), *Employers' Accounting for Postemployment Benefits – an amendment of FASB Statements No. 5 and 43*. FSP No. FAS 146-1 (as amended), *Determining Whether a One-Time Termination Benefit Offered in Connection with an Exit or Disposal Activity Is, in Substance, an Enhancement to an Ongoing Benefit Arrangement*, provides guidance on when additional termination benefits offered in connection with an exit or disposal activity are considered, in substance, enhancements to an ongoing benefit arrangement and, therefore, subject to the provisions SFAS Nos. 87, 88, 106 and 112. In addition, SFAS No. 144 addresses accounting for long-lived assets and disposal groups to be disposed of, including components of a company that are discontinued operations.

[124/] AU 316.41.

Share-based payments

Current market conditions have resulted in volatile stock prices for many companies. As a result, some companies may consider modifying share-based payment awards. In addition, the changing economic environment may affect the assumptions used when valuing such awards.

The valuation of share-based payment awards under an option-pricing model includes significant estimates, such as expected term, pre-vesting forfeiture rate and the expected volatility of the underlying stock price. For new grants of awards, companies may need to revise these and other inputs to reflect current expectations. For example, expected volatility in an option-pricing model may be affected by recent volatility in the markets. Assumptions used in the option pricing model affect the value of the award and, consequently, the compensation expense that is recognized in the financial statements.

Modifications of share-based payment awards may result in the recognition of incremental compensation cost. Incremental compensation cost is measured as the excess, if any, of the fair value of the modified award over the fair value of the original award immediately before its terms are modified.[125/]

PCAOB Staff Questions and Answers ("Q&A"), *Auditing the Fair Value of Share Options Granted to Employees*, remains relevant in the current environment and reminds auditors of their responsibilities for auditing share-based payments including consideration of –

- The company's process,
- Risk factors,
- Model selection,
- Assumptions used in option-pricing models,
- Validation of data and the option-pricing model,
- Role of specialists.[126/]

[125/] Paragraph 51 of SFAS No. 123(R) (as amended), *Share-Based Payment*.

[126/] PCAOB Staff Questions and Answers, *Auditing the Fair Value of Share Options Granted to Employees* (October 17, 2006).

In discussing the auditor's responsibilities for auditing the fair value of share options granted to employees, the Q&A refers the auditor to AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 328, *Auditing Fair Value Measurements and Disclosures*, AU sec. 336, *Using the Work of a Specialist*, and AU sec. 342, *Auditing Accounting Estimates*.

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