1999

Discussion memorandum: appraisal and valuation services, September 1999

Independence Standards Board

DM 99-3

Discussion Memorandum

Appraisal and Valuation Services

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ISB

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Standards
Board

Discussion Memorandum
(DM 99-3)

Appraisal and Valuation Services

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Comments should be received by November 30, 1999, and addressed to:
Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: DM 99-3

Comments may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to DM 99-3).

ISB

Independence
Standards
Board

Date: September 1999

To: Interested Parties

From: William T. Allen, Chairman

The mission of the Independence Standards Board (ISB or Board) is to establish independence standards applicable to the audits of public entities in order to serve the public interest and to protect and promote investors' confidence in the securities markets. While working concurrently on its project to establish a conceptual framework for auditor independence to serve as the foundation for principles-based independence standards, the Board is studying the independence concerns related to the provision of appraisal and valuation services to audit clients. As such, the Board seeks comment on the issues described in this discussion memorandum.

The operating policies of the ISB are designed to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue.

The ISB specifically seeks comments on the questions posed at the end of the discussion memo, and would welcome comments and suggestions on any other aspect of the appraisal and valuation issue.

Responses should be addressed to the Independence Standards Board, 6th Floor, 1211 Avenue of the Americas, New York, New York 10036-8775, Attn: DM 99-3. Responses may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to DM 99-3). Comments must be received by November 30, 1999.

All responses will be available for public inspection and

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Web site: www.cpaindependence.org

copying for one year at the offices of the Independence Standards Board and at the library of the American Institute of Certified Public Accountants (AICPA) at Harborside Financial Center, 201 Plaza Three, Jersey City, New Jersey.

ISB Discussion Memoranda explore auditor independence issues in an effort to solicit debate and public comment. They do not in any way modify existing auditor independence requirements.

Appraisal and Valuation Services

Discussion Memorandum

Contents

Independence Standards Board

Appraisals and Valuation Services

Executive Summary

1. This discussion memorandum is the first step in a process that will culminate in the issuance of formal independence guidance on appraisal and valuation services that audit firm professionals can or cannot provide public-company audit clients. The project developed in recognition of the need for clear guidance delineating acceptable activities versus those that would impair the independence of the auditor, and out of a desire to bring some consistency to accepted practice.

2. The memorandum discusses:

a. the current rules governing provision of appraisal and valuation services by audit firm professionals to audit clients;

b. professional standards governing appraisal and valuation specialists;

c. threats to auditor independence that the provision of these services may pose;

d. possible criteria that the Board might use in setting standards governing these services; and

e. safeguards that some suggest may be effective in protecting independence when firm professionals perform these services for audit clients.

3. Readers are asked to respond to a variety of questions following the discussion. Readers are asked whether the discussion memorandum identifies all the threats to auditor independence that these services may pose, and to comment on several alternatives that the Board might use in developing standards. The discussion memorandum also asks whether there are other distinctions among offered services that the Board could use in standard-setting. Finally, readers are asked whether safeguards could effectively protect auditor independence if audit firm professionals were allowed to provide some of these services to audit clients.

Independence Standards Board

Appraisals and Valuation Services

Background

4. The provision of certain appraisal and valuation services[1] by auditors to audit clients has received some attention from regulators and standard-setters over the past year. While some believe that providing these services could impair the auditor's independence with respect to an audit client, certain exceptions to a complete prohibition have historically been allowed. Others believe that safeguards can adequately protect auditor independence when firm professionals perform appraisals and valuations for audit clients.

5. Recently, the SEC Staff has expressed independence concerns regarding auditor valuations of "in-process research and development costs," as part of an auditor–assisted allocation of the purchase price of an acquired business to its individual assets and liabilities. This allocation assistance has historically been permitted, but the significance of the in-process R&D valuations to the financial statements of some companies has caused the Staff to question whether auditors should perform them for audit clients.

6. This focus on these services also highlighted several inconsistencies or anomalies in the existing rules, which some believe may be outdated. In addition, the Board recently issued guidance on assisting audit clients in the implementation of Financial Accounting Standards Board Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities.* That project made clear the need for general guidance as to the extent of assistance that auditors can provide audit clients in valuing assets (or liabilities) while preserving their independence. Accordingly, the Board is issuing this discussion memorandum to solicit comment on the independence issues related to auditor provision of appraisal and valuation services. The Board's objective is to develop standards delineating the circumstances in which providing these services would impair auditor independence.

7. Audit firms may provide a wide-variety of appraisal and valuation services. These services may include:

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[1] The American Society of Appraisers, a professional organization representing all disciplines of appraisal practice, defines appraising as (1) the estimation of the cost of producing or replacing physical property; (2) the forecasting of the monetary earning power of certain classes of property; (3) the valuation or determination of the worth of property. The Society defines property to include the "legal rights of ownership of tangible or intangible entities." The Merriam-Webster Dictionary (Simon & Schuster, 1974) defines "appraise" as "to set a value on," while defining "valuation" as "the act or process of valuing," the "appraisal of property." In this paper, the terms "appraisal" and "valuation" are used interchangeably, and are meant to include the process of valuing assets, both tangible and intangible, and liabilities.

a. the allocation of the purchase price of an acquired business to its individual assets and liabilities;

b. valuation of in-process research and development costs;

c. valuation of derivatives;

d. valuation of stock options;

e. calculation of pension plan and other post-employment benefit liabilities;

f. valuations for estate and gift tax purposes;

g. valuation of environmental liabilities;

h. appraisal of real estate or collateral supporting loans; and

i. valuation of insurance reserves.

Current Rules

8. The independence rules on rendering appraisal and valuation services to audit clients distinguish between:

a. firm specialists assisting the audit team in auditing a client's financial statements; and

b. separate engagements to appraise or value a client's assets or liabilities.

There are no independence concerns when audit teams use firm specialists such as appraisers to assist in auditing the fair value of a company's assets and liabilities. The concern arises when the audit firm appraiser's work becomes the client's primary support for recording amounts or the basis for business decisions (e.g., determining a buy or sell price for an asset).

SEC Independence Rules and Regulations[2]

9. In general, the SEC Staff has independence guidance which limits the auditor's ability to provide appraisal and valuation services to audit clients. Such limitations reflect concerns about auditor provision of these services which include:

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[2] "No action" letters issued by the SEC Staff: Touche Ross & Co., December 10, 1985, Kenneth Levanthol & Company, May 24, 1988, and Pannell Kerr Forster, July 11, 1988.

a. the possibility that the auditor would not be objective in reviewing the value of an asset or liability calculated by a colleague or group within his or her firm (i.e., concerns related to "self-review").

b. development of an inappropriate "mutuality of interest" between the auditor and the client. Appraisal and valuation methodology often involves the use of cash flow projections, or other forecasts of the company's future results.[3] The concern is that the auditor could become committed to projections used in the appraisal that he or she may have developed or assisted the client in developing – projections also used in determining whether, for example, asset impairments have occurred, or the company will be able to satisfy its obligations to creditors.

c. The decisions required in the valuation process have been characterized as "management responsibilities," which conflict with the responsibilities of the auditor. Activities that are generally considered management responsibilities include consummating transactions, having custody of assets, and otherwise exercising authority on behalf of the company. With respect to appraisals and valuations, activities that might be considered responsibilities of management include the pricing of a company's product, or determining the sales price of a subsidiary or other asset.

10. The auditor is permitted, however, to provide appraisal and valuation services in certain circumstances. For example, auditors have historically been permitted to assist the client in allocating the purchase price of an acquired business to its individual assets and liabilities, in a purchase business combination, which often results in the auditor performing some valuation work. Some have suggested that this exception to the general rule was based on:

a. the fixed total to be allocated to individual assets and liabilities (the actual purchase price of the acquired business);

b. the "brick and mortar" or relatively straightforward nature of assets and liabilities in the past. Typically, companies have not had the level of intangible assets or complex financial instruments, for example, that are common today; and

c. the typically long life over which the appraised assets (e.g., property, plant, and equipment) were amortized, making the annual impact of any incorrect amounts less likely to be significant.

11. Other auditor allocations of fixed amounts have been prohibited, even if they do not have direct financial statement consequences. For example, the auditor cannot allocate the market value of a company, represented by the value of its publicly-traded stock, among the company's three divisions. Presumably, the theory behind the prohibition is that cash flow or other

[3] The terms "prospective financial information," "projections," and "forecasts" have specific meanings in the auditing literature. They are used informally, however, in this paper, and as synonyms.

projections would be prepared to support the value of each division, and these projections, for example, may impact an asset impairment evaluation, or the auditor's assessment of whether debt covenant violations are on the horizon. The auditor may be biased towards forecasts he or she prepared or assisted in preparing, when an objective analysis of these projections would reveal that they required substantial revisions. Some also believe such valuations involve more judgmental matters than purchase-price allocations would typically involve.

12. Historically, the SEC Staff has not objected to auditor-provided appraisals for estate tax purposes. In some cases, however, the results of these appraisals can have financial statement consequences. Auditors have also been permitted to value employee benefit plan liabilities for audit clients, possibly because generally accepted accounting principles require the amortization of any changes in the valuation from year to year, thus reducing the impact of the changes on annual earnings.

<u>AICPA Rules Applicable to All Auditors</u>

13. In performing appraisals, all auditors must comply with the independence requirements of the American Institute of Certified Public Accountants (AICPA) (auditors of public companies must also comply with SEC rules where these are more restrictive). AICPA rules currently permit auditor performance of appraisal or valuation services, the results of which may be incorporated in the audit client's financial statements, if all of the significant matters of judgment involved are determined or approved by the client, and the client is in a position to have an informed judgment on the results of those services.[4] In addition, under Statement of Auditing Standards No. 73, *Using the Work of a Specialist* (SAS 73), the auditor has certain responsibilities when relying on the work of a specialist, including an appraisal or valuation expert on the audit firm's staff. When relying on a specialist, SAS 73 requires the auditor to assess the:

a. professional qualifications of the specialist;

b. objectives and scope of the specialist's work;

c. relationship between the specialist and the client (i.e., the specialist's objectivity);

d. methods or assumptions used;

e. methods or assumptions used compared to those used in the preceding period;

f. appropriateness of using the specialist's work for the intended purpose; and

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[4] *AICPA Professional Standards: Code of Professional Conduct,* Interpretation 101-3 Under Rule of Conduct 101: Performance of Other Services.

g. the form and content of the specialist's findings – information provided must allow the auditor to obtain an understanding of the methods and assumptions used, make appropriate tests of the data used by the specialist, and evaluate whether the findings support the related assertions in the financial statements.

14. SAS 73 does not apply to situations where firm specialists directly assist the audit team in performing the audit.

SEC Practice Section Rules[5]

15. The AICPA's SEC Practice Section also has membership rules for audit firms, including ones governing provision of actuarial services to insurance company audit clients. Because the actuarial function is basic to the operation and management of an insurance company, the Practice Section rules conclude that the CPA firm cannot assume responsibility for this function without jeopardizing its independence. Therefore, the CPA firm cannot provide actuarial advisory services to an audit client involving the determination of policy reserves. Rather, the client must have its own actuaries (internal or external) that provide primary actuarial capabilities.

Standards Governing Appraisers and Valuation Experts

16. Appraisers themselves have ethical codes and professional standards, which recognize the responsibilities and obligations that these professionals have to the public and their profession, beyond those due to their clients. For example, the Appraisal Institute's[6] *Code of Professional Ethics* states that ".....[because] proper appraisal, consulting, and review gives stability to real estate loans and investments and this in turn helps to promote public confidence in the economy that sustains a free society.....ethical responsibilities and obligations are due to both the public and the profession." The ethics provision of the *Uniform Standards of Professional Appraisal Practice*, issued by the Appraisal Standards Board,[7] states that the appraiser "must perform assignments with impartiality, objectivity, and independence and without accommodation of personal interests.....it is unethical for an appraiser to use or communicate a misleading or fraudulent report or to knowingly permit an employee or other person to communicate a misleading or fraudulent report." *The Principles of Appraisal Practice and Code of Ethics of the American Society of*

[5] *SEC Practice Section Reference Manual,* SECPS §1000.35. The SEC Practice Section membership consists of most firms that audit public companies. Members of the Practice Section must comply with its rules and regulations.

[6] The Appraisal Institute is a professional organization for commercial and residential real estate appraisers with 19,000 members. The Institute offers professional designation programs, and members must adhere to its *Code of Professional Ethics*.

[7] The Appraisal Standards Board is part of The Appraisal Foundation. The Board's *Uniform Standards of Professional Appraisal Practice* are recognized throughout the U.S. as the generally accepted standards of professional practice for real estate, personal property, and business appraisal. Over eighty organizations, corporations, and government agencies are affiliated with The Appraisal Foundation, as Sponsoring Organizations or Advisory Council members.

Appraisers[8] recognizes the appraiser's fiduciary relationship to third parties, stating that "[m]embers of the Society recognize their responsibility to those third parties, other than the client, who may be specifically entitled to make use of their reports."

17. The ethical standards governing the appraiser do not permit association with a report that the appraiser believes is misleading, even if the report clearly states that the client, rather than the appraiser, takes responsibility for the assumptions and judgments inherent in the work. Therefore, to comply with both the appraisal standards and AICPA rules governing auditors, an appraiser (whether or not associated with the audit firm) and the firm's audit client must, in effect, agree on the assumptions and judgments inherent in the appraisal. The AICPA's requirement for appraisals performed for an audit client - that "all of the significant matters of judgment involved are determined or approved by the client" - does not diminish the appraiser's obligation to stand behind his or her work and the assumptions inherent in that work, even though the audit client also takes responsibility for these assumptions and judgments.

Threats to Independence

Self-Review

18. Some believe that the "second look" – the review of the financial statement amounts by a second, impartial party – is fundamental to auditing. They believe that auditors may lack the requisite skepticism when reviewing their own work or the work of colleagues in their firms. Or worse yet, the auditor may be reluctant to challenge the work of a colleague, or to disclose and insist upon correction of a colleague's error. The notion that the auditor should not be placed in the position of auditing his or her own work (or the work of a colleague) centers on these concerns related to "self-review."

19. Others argue that auditors successfully contend with the requirement to review and get comfortable with the work of many specialists or consultants in their firm. For example, the audit partner reviews the work of firm specialists performing tax work such as preparation of tax returns for a client. Presumably these auditors are occasionally faced with the responsibility of pointing out and correcting errors made by their colleagues. Or, the audit team may find itself auditing books and records produced by a computer system that its consultants assisted the client in installing. In addition, in performing an audit, auditors sometimes discover misstatements in prior year financial statements upon which they previously reported, necessitating restatements and discussion in the auditors' report. This group believes that auditors face these conflicts periodically, and that there is no widespread evidence that

[8] The American Society of Appraisers is a professional organization representing all disciplines of appraisal practice. Each accredited member of the Society must possess a professional designation in one or more specialized areas of appraisal, pass written technical and ethics examinations, and submit appraisal reports for peer review.

auditors have failed to thoroughly review the work of colleagues, or that they have hidden their own or their colleagues' mistakes.

20. Proponents of firm provision of these services to audit clients would argue that current rules (SAS 73) require the audit team to carefully review the work of a firm appraiser engaged by the client. Required audit procedures are the same whether the appraiser is a firm specialist or a third party. In addition, other audit rules, such as those governing second partner reviews, and the way in which firms structure audit engagements often result in several firm auditors reviewing the same reports and support for account balances provided as audit evidence. In many cases, depending on audit risk and materiality, there are separate reviews by the senior accountant, manager, partner, and second partner. This group believes that these multiple reviews effectively dispel worry over losing the "second look" provided by the audit.

Mutuality of Interests and Acting in the Capacity of Management

21. Some argue that valuations of non-financial statement items performed by the auditor also threaten the auditor's independence. Because appraisal methodology often involves projections of future cash flows and results, they believe that the auditor developing such forecasts may later fail to question them or assess them with the requisite skepticism, when they are subsequently used to support the reported value of an asset or liability on the financial statements. The auditor and the client will have a "mutual interest" in rationalizing such a forecast. In addition, this group asserts that the decisions made by the valuation specialist are "management decisions" that should not be made by the auditor.

22. Others believe that projections and forecasts are recognized by auditors, appraisal professionals, companies, and users of financial statements as estimates, and that changing circumstances or unforeseen events do not mean that the original projections or valuations were inappropriate when issued. This group argues that the auditor would not feel compelled to accept stale projections originally developed by a firm appraisal specialist when these projections showed outcomes that were no longer likely of realization. They contend, for example, that auditors routinely argue for increases (or decreases) in loss reserves, even when firm specialists and the audit team "signed-off" on such reserves in the prior year. In addition, current rules permit the auditor to report on prospective financial information,[9] a practice which some argue would pose the same risk of the auditor becoming committed to a set of projections. Yet performance of these services has not been identified as the cause of subsequent auditor independence problems.

[9] Current independence rules allow the auditor to report on, but not prepare, prospective financial information that may be used by third parties in accordance with certain guidelines.

23. Some believe that third-party appraisers – those not connected to either the client or the audit firm – may have more of a bias in favor of the client's interests (a mutuality of interests) when performing an appraisal. While appraisal professionals have an ethical code of conduct and standards requiring that they perform their work impartially and in an unbiased manner, some argue that it is very difficult not to have *some* bias in favor of the interests of a paying customer. The fact that an appraiser works for the firm that performs the audit of the client's financial statements may provide an added incentive to perform the work objectively.

24. On the other hand, if fees have an adverse effect on objectivity, some believe that effect is compounded when the client is also paying an annual audit fee. The third-party appraiser may have more infrequent engagements with the client, which some believe would lessen the desire to compromise objectivity to please the client. Countering that is the argument that the size of the total fees should be compared to the firm's total revenue, if there is a concern that fees can adversely influence objectivity.

Possible Criteria for Standard-Setting

Materiality and Efficiency

25. Some contend that valuations of immaterial assets or liabilities by specialists in the audit firm do not impair auditor independence. They may acknowledge the threats to auditor independence that some suggest are posed by firm provision of these services – the threat of self-review and a mutuality of interest with the client. They believe, however, that services should not be proscribed unless they threaten audit quality, and ask how these threats could impact audit quality when the amounts being appraised or valued are immaterial to the financial statements. Consequently, they believe that the rules should only prohibit firm provision of appraisal and valuation services to an audit client when the amounts involved could have a material impact on the client's financial statements.

26. Others suggest that materiality is difficult to define, especially when the result of the service itself is an estimate of value. They ask why the rules should allow immaterial valuations for audit clients, when others parties uninvolved in the audit can provide them just as competitively. The audit firm has only a minimal efficiency advantage in performing these services, they believe, and the relatively small fees that could be earned from valuing immaterial items would be offset by the cost of additional safeguards imposed to protect auditor independence. This group believes that an audit firm appraiser would not have any special knowledge of the client's affairs that would enable a more efficient or effective appraisal project.

27. Others contend that if there is no significant threat to independence, the marketplace should determine whether the auditor has an efficiency advantage. They argue that the client may be comfortable with the quality of its audit firm and the professionalism of its specialists, and may not have the time to

research the reputation and qualifications of other specialists. Audit firm personnel, who may have a rapport with client management, may be able to quickly locate the right specialists within the firm to satisfy the client's valuation requirements. In addition, if the auditor uses the work of a *firm* specialist, engaged by the client to appraise certain assets or liabilities, then compliance with the requirements of SAS 73 is easier and more efficient. For example, the auditor would not have to assess the qualifications and reputation of the specialist, as this would already have been done on a firm-wide level.

28. Contributing more to efficiency, and more importantly, to audit quality, this group argues, would be the auditor's good rapport with a firm specialist. They believe that a firm specialist would be more inclined than a third party to quickly respond to the auditor's request for the data and assumptions used in the valuation (so that the auditor could test them), and to explain the scope, purpose, and results of the work performed. More significantly, a third party appraiser, some believe, may have a certain reluctance to be completely open, frank, and thorough in his or her conversations with the client's auditor – a reticence that most would not expect from a specialist connected with the audit firm.

29. Supporters also believe that a service should not be proscribed unless its provision poses a significant risk to auditor independence. They do not believe that the auditor's independence is impaired when a firm specialist values immaterial items.

30. Somewhat related to the "efficiency" argument is the belief of some that strong valuation expertise resident in the audit firm contributes to audit quality. This group believes that auditors today need the expertise of a variety of specialists to perform an effective audit. Having that expertise within the firm contributes to efficiency. They believe that the ability to provide a wide variety of professional opportunities to such experts is important in attracting and retaining the best talent. They believe that unnecessary restrictions on the work that firm specialists can perform for audit clients hinders the firms' ability to retain high caliber professionals.

31. Others disagree with this argument, pointing out that restrictions on services that can be provided by firms to audit clients do not impair the firms' ability to provide professional opportunities to firm specialists. Theoretically, the pool of work available to specialists working for audit firms is not reduced just because firms cannot provide certain services to audit clients, they contend.

Level of Judgment Required

32. Another way to approach standards for auditor provision of appraisal and valuation services may be to allow those where:

a. the methodology used is well-established and there are few, if any, choices among alternative methodologies; and

b. the required assumptions are more routine, based on published statistics, or less subjective.

33. For example, an accepted methodology for valuing stock options is the Black-Scholes model – a model that is well-established and not subject to a great deal of variation. While specialists using the model may not have identical results, some believe differences in value are not likely to be material. They contend that the information about the options that must be provided is both objective and subjective. *Assumptions* such as volatility and expected dividend yield are largely based on trading history, however, and the expected option life, an estimate, is based on some factual data, such as the option's term, vesting period, past history for similar grants, and stock volatility. Thus, they assert, the model produces consistent results in the hands of different specialists. They argue that the independence rules should allow the auditor to perform these routine valuations for audit clients, even if appraisals requiring a higher degree of judgment are prohibited. The lack of judgment involved in some valuations, they believe, mitigates the threat that the auditor is assuming management functions.

34. Others may agree with the rationale behind such a distinction in the independence rules – a distinction based on the level of judgment involved in the valuation – but ask whether rules like these would be operational. It may be difficult to assess the level of judgment involved in some valuations prior to accepting the engagement, and diversity in practice might result if the assessment were left up to the individual professional or firm. Alternatively, rules could incorporate a list of common services that are permitted versus those that are prohibited; some believe, however, that such detail in an independence standard is undesirable, and does not provide guidance to professionals on new engagements or those not covered by the rule.

Level of Comfort Requested from the Appraisal / Valuation Specialist

35. Some believe that the independence rules regarding auditor provision of appraisal and valuation services should make distinctions based on the level of comfort expected from the audit firm valuation specialist. For example, in some European countries, a company's auditors may be asked to report on assets contributed to the company in exchange for company stock ("contribution-in-kind" reports).[10] These reports describe the non-cash consideration contributed and the methods used (by third parties) to value the assets, and state whether the value of the contributed assets is at least equal to the value of the shares issued in exchange.

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[10] Some countries (Sweden, Belgium, and Italy) currently require that the company's auditor furnish the contribution-in-kind report, creating a problem for auditors of SEC registrants in these countries in complying with both SEC and local rules. The SEC Staff has objected to audit firm issuance of these reports for audit clients, stating that the firms would not confirm that their reports do not express an opinion on the fairness of the transaction, the value of the security, or the adequacy of consideration to shareholders.

36. Current rules prohibit the auditor from issuing "fairness opinions" for audit clients – an opinion, for example, on the fairness of the proposed purchase or sale price of an asset or business, or of an exchange ratio in a business combination. The SEC Staff has also objected to auditor issuance of these contribution-in-kind reports, as the Staff believes that they are akin to fairness opinions. Others argue that these reports are fundamentally different from fairness opinions, in that the auditor reviews the valuations prepared by others in issuing a contribution-in-kind report, and the report issued clearly notes this reliance. In contrast, in issuing a fairness opinion, the specialist *performs* the underlying valuation work. Proponents of auditor provision of these services analogize to the rules governing prospective financial information; the auditor cannot prepare this information for an audit client, but is permitted to examine and report on projections and forecasts prepared by others. They assert that the independence rules governing appraisal and valuation work should make distinctions based on the level of responsibility assumed by the auditor. Independence standards, they believe, should permit valuation engagements that are more akin to a review of another's work, as this is a natural counterpart to the audit function.

Disclosure of Assumptions in the Financial Statements

37. In setting standards, others would allow routine valuations, such as those performed for pension and other post-employment benefit liabilities, where disclosure in the financial statements is required of the assumptions used. The reasoning behind this proposed exception is that the appraiser may be more likely to maintain objectivity knowing that the significant assumptions inherent in his or her work would be publicly disclosed in detail in the financial statements.

38. Others might argue that financial statement users should not have to assess the reasonableness of the assumptions inherent in a valuation expert's work. This, they believe, is the job of the auditor. They contend that disclosure of such assumptions does not mitigate the potential for diminished auditor objectivity resulting from the fact that the auditor's colleagues performed the underlying work. Just as some believe that disclosure is no cure for bad accounting, they would argue that disclosure is no cure for impaired independence.

Financial Statement Impact

39. Some may believe that the threats to auditor independence posed by self-review are sufficient to warrant prohibitions against auditors appraising financial statement items. They may not believe, however, that the "mutuality of interests" threat is compelling, and accordingly, would allow audit firms to value non-financial statement items for audit clients. Therefore, they would permit the auditor, for example, to allocate the market capitalization of an audit

client to its separate divisions, but would prohibit a derivatives expert from the audit firm from valuing that client's derivatives portfolio.

40. Or, standards could distinguish between valuation work that might have a direct impact on the financial statements of an audit client, versus work that may only have an indirect effect. Rules might be structured to permit the audit firm to perform appraisals for tax purposes, which have indirect financial statement consequences, and to value the collateral supporting a loan, even though such an appraisal may result in an indication of loan impairment. On the other hand, such rules would prohibit the auditor from determining the amount that the audit client should record to reflect its environmental liabilities.

41. Others might argue that some valuation work, regardless of financial statement impact, places audit firm professionals too much in the role of management. They would ask whether investors would feel comfortable knowing that audit firm professionals advised the audit client on the price to pay for a business, or on how much to charge for their products. They believe that the auditor requires a certain perspective and distance from the client to perform effectively, and that provision of these services inappropriately "blurs the line" between the auditor and management.

Potential Safeguards

Additional Reviews

42. Some believe that appraisal specialists in audit firms can effectively perform appraisals and valuations for audit clients without impinging on audit quality only if certain safeguards to protect auditor independence and objectivity are employed. For example, SEC Practice Section standards currently require review of the audit engagement by a second partner (the concurring reviewer). This second review is not meant to duplicate the work done by the engagement partner and other senior audit personnel in its entirety. Instead, the second review is focused on the riskier aspects of the audit – on those areas where there is a great degree of judgment required on the part of the auditor. If audit firms were allowed to perform appraisals for audit clients, then the second review could also focus on the appraisal project and its impact on the audit as a result of any potential threats to auditor independence. Standards could require the reviewer to make specific inquiries regarding audit client sophistication and management's ability to evaluate assumptions and results. These rules could also require the reviewer to ascertain whether the audit team evaluated the appraisal with appropriate skepticism, and whether the team complied with the requirements of SAS 73.

43. In addition, the concurring review could assess the audit team's overall program of safeguards with respect to firm valuation work, and compliance with requirements could be tested in peer review (review of the firm's quality control procedures by an outside firm – a requirement for AICPA SEC Practice Section members) and in internal inspections conducted within the firm.

44. Others suggest that a similar concurring review requirement could be imposed on the appraisal or valuation work performed by the valuation specialists in the audit firm. They believe formal policies should be established requiring review of all firm valuation work by a second firm appraiser. Although the audit team may still be subject to the threats to independence identified in this discussion memo, ultimately, financial reporting problems are more likely when the original valuation work is somehow flawed (and less likely when the work is done right). Using similar reasoning – that quality work mitigates the threats to accurate financial reporting posed by audit firm provision of non-audit services, including appraisals and valuations – and in response to self-review concerns, they would suggest requirements to have a third party, for example, check software programs used by the firm to perform this work. Some believe that this safeguard could be combined with others to adequately protect the independence of the audit team when firm specialists perform appraisal and valuation services.

Discussion of Services Performed with the Audit Committee

45. The Independence Standards Board's Standard No. 1, *Independence Discussions with Audit Committees*, requires the auditor to disclose in writing and discuss with the audit committee of the client all relationships between the auditor and the company that may reasonably be thought to bear on independence. If auditor provision of appraisal and valuation services were permitted, some believe the requirement to discuss these services with a company's audit committee would help protect auditor independence. Knowledge that the services provided will be discussed with the audit committee, as surrogates for shareholders, may bring additional focus to potential independence threats, and ensure that appropriate safeguards are in place to preserve the independence of the audit team.

Audit of a Subsidiary by Another Firm

46. Another suggested safeguard is to require another accounting firm to perform the audit of any subsidiaries for which the primary auditor performed valuation work. The primary auditor would rely on the audit of the subsidiary performed by the other firm – a firm that would not be subject to the independence threats posed by the performance of appraisal and valuation services. Even if the second auditor is in the position of using the primary auditor's appraisal or valuation report as audit evidence, this group argues, the second auditor wouldn't have any reason to view the report with less skepticism than a report from a third party. Others believe that the rules should combine this safeguard with the ability to assess the materiality of the valuation services provided by the auditor. They do not see why a separate audit should be required (with the degree of precision associated with an audit of an individual company versus the precision required when the company is part of a consolidated group) if the subsidiary itself is immaterial to the consolidated financial statements, or if the valuation work performed by the auditor is inconsequential.

Firewalls

47. Finally, some believe that firewalls could effectively separate the audit team from the appraisal and valuation specialists in the audit firm. If these groups were located in separate divisions, each with a separate group of supervisors, they argue that some of the concerns would be mitigated related to self-review and the development of an inappropriate mutuality of interests between the audit team and the client. Existing audit rules require the auditor to communicate with firm personnel responsible for non-audit services if such services might result in information that has audit implications.[11] This group contends, however, that firms could be structured so that the audit team's motivation to question less skeptically the work performed by others within the firm would be minimized. In addition, if the auditor did not identify strongly with the firm appraisal specialists because of structural separation within the firm, the risk of the auditor developing a mutuality of interests with the client because of jointly-developed projections would diminish. Others disagree with this contention, arguing that the auditor's objectivity could be influenced by the knowledge that the appraisal or valuation was prepared by a professional within his or her firm, even if the audit and appraisal groups were structurally distinct and isolated.

Questions for Respondents

Q1. Has the DM identified all the threats to auditor independence posed by auditor provision of appraisal and valuation services? If not, please describe the additional threats and whether they should result in any proscriptions of services by auditors.

Q2. Should standards governing auditor provision of these services make distinctions based on the materiality of the appraised items? If so, how would you judge materiality?

Q3. Are there benefits that may exceed the costs – the potential threats to independence - of allowing audit firms to provide these services to audit clients? If so, what are these benefits?

Q4. Do you believe that the methodology used in some appraisals is more established and subject to fewer alternatives than in others? Are the required assumptions in some appraisals more routine, based on published statistics, or otherwise less subjective than in others? If you believe that these differences exist, should auditor independence standards make distinctions based on these differences? If so, please provide some examples of services that should be permitted as well as those that should be prohibited.

Q5. Should auditor independence standards governing these services distinguish between engagements where the valuation specialist is performing the underlying valuation work versus those in which he or she reviews and

[11] *AICPA Professional Standards,* AU Section 311.04(b), *Planning and Supervision.*

relies upon the work of third parties (e.g., European contribution-in-kind reports)?

Q6. Do you believe that standards should allow firm specialists to value financial statement amounts for firm audit clients when the assumptions inherent in the valuation work are fully disclosed in the financial statements?

Q7. Should auditor independence standards governing these services distinguish between appraisals and valuations that have a direct financial statement impact versus those that have no financial statement consequences, or only indirect consequences? If so, how would these standards operate?

Q8. Are there other distinctions that these standards should contemplate?

Q9. Do you believe that the safeguards outlined in the DM could effectively protect auditor independence when the audit firm provides appraisal and valuation services to an audit client? Are there other safeguards that would be effective?

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