

# Point of view

## Audit Committee

Fair value and the role of the audit committee



### Why oversight by the audit committee is important

In the last two decades, financial reporting requirements have increasingly called for the measurement of assets and liabilities at fair value. Basically, this affects the following areas:

- The valuation of financial instruments
- The estimation of realisable values in relation to asset impairment
- The valuation of assets and liabilities acquired due to business combinations

Entities are required to disclose in the notes to the financial statements information on the valuation process and the exercise of judgement to substantiate the calculation of fair value.

Fair value is based on the selling price of transactions between participants in the market. But it can be subjective and it requires the exercise of judgement if there is no stock market price or a comparable transaction available. In such cases, management has to determine the fair value on the basis of valuation methods and assumptions. These may be developed either by the entity itself or with the support of external valuation experts.

Increasingly, financial institutions have to determine the fair value of financial instruments as part of their day-to-day activities. The growing use of fair value in financial reporting means that companies across all industry sectors often have to collect and disclose information regarding valuation.

The audit committees of companies for which fair value plays a significant role also have to address this matter as part of their financial reporting oversight duties. In light of this, audit committees may need to consider the following factors:

- The extent to which extensive changes in business activity or the market environment can affect fair value now and in the future
- The assessment of the valuation process and the related controls
- The role of internal audit and the external auditor

## How audit committees oversee calculation of fair value

### *a. Using fair value*

Companies assess fair value as part of their financial risk management strategy (for example, in hedging commodity prices or changes in foreign currency rates). As financial reporting standards have developed, fair value is now being used more than historical cost. This is the case for derivatives and most other financial instruments as well as accruals and deferrals of pension schemes, assets held for sale, estimation of realisable value in relation to asset impairment, and valuation of assets and liabilities acquired in business combinations.

If companies use fair value, they have to disclose the valuation method, the assumptions they use and the resulting sensitivities. The fair values of financial assets and liabilities also have to be disclosed, even if these items are not recognised at fair value in the balance sheet. For example, a company has to disclose the fair value of its existing liabilities.

### *b. The complexity of fair value*

Valuations based on fair value can be very straightforward; for example, a listed share will usually have a price on an active market. But market values or comparable transactions are not always available for some assets, such as derivative financial instruments or plant and equipment depreciated on the basis of impairment tests. In such cases, valuation methods are used to estimate the fair value. This means that fair value depends on judgement or subjective assessments, which can lead to significant fluctuations in value.

Under the financial reporting requirements, the models and assumptions used to determine fair value must match those used by other market participants. Nevertheless, it is up to the entity itself to decide on the valuation model and the assumptions used in view of the markets in which the assets were acquired or liabilities were entered into. Because the determination of fair value involves an element of judgement, it can lead to greater financial reporting risks when it comes to accounting – as is the case with other estimates.

In addition, fair value can be very sensitive to changes in assumptions. Assets that are not measured on the basis of stock exchange prices will fluctuate every time there is a change in the assumptions. Such changes arise from the markets or the business model in question.

Irrespective of their origin, even small changes in the assumptions can have a major impact on the balance sheet and the income statement.

### *c. Fair value is used by companies across all industry sectors*

Fair value is relevant for financial institutions because their business model primarily involves financial assets and liabilities. However entities in other industries often have to measure or disclose at least some individual assets and liabilities at fair value too. Outside the financial sector, assets and liabilities that are not part of the daily business have to be measured at fair value. For example, companies hedge various business risks by means of derivatives, acquire other businesses or perform impairment tests on assets – all of which require the calculation of a fair value. Considerable fluctuations in value can arise from these calculations, with a corresponding impact on a company's published results.

### *d. Understanding the risk relating to management compensation*

Employee participation plans, especially those for executive management, are often linked to the entity's share price or operating earnings. Similarly, the fees earned by asset managers and stock exchange traders are usually tied, at least to some extent, to the performance of the portfolio they manage. Audit committees that are aware of this relationship can better understand how to manage and monitor the valuation processes and take account of the connection between financial reporting and the risks relating to management compensation.

### *e. Regulators focus on fair value*

The requirement for valuations to be based on fair value has prompted regulators as well as stock exchange and audit oversight bodies to focus more on this aspect. In October 2015, SIX Exchange Regulation (SER) published its updated Circular No. 2 on International Financial Reporting Standards (IFRS), stating its position on fair value in relation to the impairment of assets, financial instruments and business combinations. The circular aims to make the duties of issuers more precise and raise their awareness for IFRS rules whose application had given the SER grounds for criticism.

A company's management team has to make estimates. In some cases, it may rely on the support of external experts or banks. However, such estimates remain the management's responsibility. As the board of directors is

ultimately responsible for the statutory and consolidated financial statements, the audit committee (and the board of directors as a whole) has to monitor the work of management in this regard.

### ***f. Understanding the use of fair value***

One of the basic responsibilities of the audit committee is to oversee financial reporting and the financial reporting process. Given the degree of complexity and subjectivity involved, estimates and fair value often play a particular role in this context.

We advise audit committees to discuss thoroughly the use of fair value with both management and the auditors. Where necessary, the auditors should present their view of the risks associated with the valuation process, the extent to which judgement has been exercised, and the fluctuations in value that may arise.

Here are some of the key questions audit committees should ask management:

- Does the company perform valuations internally or does it involve external valuation experts?
- Which valuations are based on market prices and which on valuation models?
- What are the major assumptions? How were these assumptions arrived at? How sensitive are values to changes in these assumptions?
- How does management rate the appropriateness of the fair value calculations performed in-house or by external experts?
- How were the external experts selected? What qualifications do they have?
- If the calculation results in a range of possible values, how does management determine the recognised value? Has it made any changes to values?

Depending on the materiality and subjectivity of the estimates, or the composition of the audit committee, specific training might be helpful.

## **In a nutshell**

The audit committee's duty to oversee financial reporting requires it to assess the determination of fair value. This primarily involves the following:

- Thinking about the extent to which major changes in the business model or market context impact fair values now and in the future
- The valuation process and the related controls
- The role of internal audit and the external auditor

By adopting a systematic approach to these matters, audit committees can help enhance the transparency of financial reporting.

## **Frequently asked questions**

### ***a. How can audit committee members monitor the determination of fair value in cases where external experts are not involved?***

There's no patented recipe for the composition of audit committees. Each committee has to decide for itself whether it's adequately structured, depending on the industry sector, the operational risks, the business activities and transactions, and the risk profile. To be able to monitor the risks of financial reporting and fair value, an audit committee should bring together people with different skills and abilities – in particular, a variety of points of view, experience and willingness to ask critical questions of management.

### ***b. Besides the questions about recognition and valuation, what are the disclosure rules when using fair value?***

Depending on the financial reporting standards, a number of disclosures are required. These cover different classes of assets broken down into three groups and structured hierarchically according to the observability of values and the underlying assumptions. The most comprehensive disclosures are required for measurements for which the fewest observable values and assumptions are available (Level 3). Under IFRS a table of the material unobservable inputs used in the calculation of fair values should be presented. Entities must also provide a qualitative description of the valuation process.

## Your contacts

If you have questions or would like to discuss issues concerning the role of the audit in more depth, please feel free to contact our experts.

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Figure 1: The 'four lines of defence' model<sup>1</sup>



<sup>1</sup> Cf. European Confederation of Institutes of Internal Auditing ECIIA/Federation of European Risk Management Associations FERMA (2010), pp. 9-10