ISB Interpretation 99-1

> The Independence Standards Board (ISB) is examining the broader issue of an auditor's association with valuations and fairness opinions. This interpretation, which is based on existing guidance, will not be considered precedent when the ISB addresses the broader issue and may be subject to change based on the ISB's conclusions reached after the public comment process.

Independence Standards Board
Impact on Auditor Independence of
Assisting Clients in the Implementation of FAS 133 (Derivatives)

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Issue

1. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standard No. 133, "Accounting for Derivative Instruments and Hedging Activities" (FAS 133). FAS 133 requires that all derivatives be recorded on the balance sheet at fair value. Changes in fair value flow through the income statement, unless the instrument qualifies as a hedge, as defined. The statement is effective for fiscal years beginning after June 15, 1999, but companies can adopt the statement as of the beginning of any fiscal quarter that begins after June 1998.

2. For many companies, the complexity of the statement and of the underlying financial instruments will make the implementation process difficult. Company management may need help in understanding the statement's requirements; derivatives must be identified, inventoried, and measured at fair value; hedging relationships must be designated anew and documented as of the implementation date; and many companies will need system modifications in advance of implementation to develop and track the various required fair value measurements.

3. As a consequence of the complexity and implementation challenges inherent in adopting FAS 133, audit firms are likely to find themselves responding to many types of client requests for assistance. This interpretation provides guidance on the auditor independence implications of likely areas of requested assistance, solely with respect to the implementation of FAS 133.

Independence Concerns

4. As it considered these issues, the Board discussed the potential threats to auditor independence. Appraisals and valuation services potentially threaten the auditor's independence because of a "self-review" concern. Under the existing rules, the auditor cannot be placed in the position of "auditing his or her own work" (or the work of someone else in his or her firm). In addition, acting in a capacity equivalent to that of management is viewed as a threat to auditor independence. The auditor may lose his or her objectivity if he or she makes decisions for or develops a mutuality of interest with the client by, for example, valuing the client's assets.

ISB Discussion and Interpretation

5. The Board considered two broad areas of likely assistance and how the existing independence rules would be applied. One category of services relates to the accounting application and the second involves valuation consulting services.

6. Management is responsible for the financial statements, and responsibility for the choices and judgments inherent in the preparation of those financial statements cannot be delegated to the auditor or to anyone else. Whatever the service being provided, the auditor must understand the level of management's expertise and must be satisfied that management has taken responsibility for the assumptions and judgments made during the course of the work, and for the results produced.

7. The Board has concluded that the auditor may provide consulting services on the proper application of FAS 133, including assisting a client in gaining a general understanding of the methods, models, assumptions, and inputs used in computing a derivative's value. To ensure, however, that the auditor's independence is not threatened, as discussed in paragraph 4, the auditor may not prepare accounting entries, compute derivative values or be responsible for key assumptions or inputs used by the client in computing derivative values.

8. The auditor's independence would be impaired if he or she created the initial journal entries that are used to implement or apply the standard, or if in providing the services described below, the auditor's level of assistance was tantamount to doing the work himself or herself.

9. Based on these general guidelines, the following is a list of illustrative services that the auditor may be asked to provide an audit client in implementing FAS 133, along with the Board's conclusions on which of these would impair the auditor's independence.

<u>Accounting Application Assistance</u>

10. Accountants are likely to work with clients in implementing the accounting requirements of FAS 133. Providing guidance to clients (which for this purpose encompasses discussing the requirements of FAS 133, providing advice, and expressing views as to how FAS 133 would be applied in the client's situation) would not impair independence. Performing services which would be subject to audit procedures such as compiling the inventory of derivatives, creating the

initial journal entries to be recorded, initially determining whether specific derivatives meet the relevant criteria as hedges, or making management decisions concerning the implementation of FAS 133 would impair the auditor's independence.

11. The provision of the following services would not impair the auditor's independence:

a. Discuss the requirements of FAS 133 and the related concepts, terminology and implementation issues.

b. Provide sample journal entries used to apply FAS 133.

c. Provide guidance in compiling an inventory of derivatives, as defined by the new rules.

d. Provide guidance in determining whether specific derivatives meet the relevant criteria as hedges, or provide examples and discuss factors to be considered in formally documenting any hedging relationships and the entity's risk management objective and strategy for undertaking the hedge.

e. Discuss factors to be considered in making judgments that may become critical in the accounting process, including the separation of the intrinsic value of instruments from their "time value." This separation of an instrument's fair value into its component parts might have accounting consequences within the financial statements (FAS 133 permits the exclusion of the inherently ineffective portion of a derivative's change in value, such as the time value of options, from the "hedge effectiveness" assessment).

f. Provide guidance in determining the accounting for hedged items.

g. Provide guidance or assist management in developing and adapting systems to account for derivative instruments and hedged items under the new standard.

<u>Valuation Consulting Assistance</u>

12. The provision of the following services would not impair the auditor's independence:

a. Provide guidance or assist in developing the client's own valuation model. The client takes responsibility for the model, by testing, evaluating, approving, and running it.

b. Provide guidance on the nature of relevant model inputs (volatility, yield curves, etc.) and related market sources of information. The client makes the final decision as to the inputs and market sources of information to be used.

c. Validate client or third-party models used.

d. Validate reasonableness of inputs to models (client assumptions).

e. Provide a generic/standardized product (e.g., not unlike a Black-Scholes or binomial software model used for valuing options), which a client uses in valuing its derivative instruments. A generic or standardized product is one in which formulas are well-established and subject to only minor judgments or interpretations. It is reasonable to expect that the result produced by such a product will be similar to the result that would be produced by another vendor's product.

13. The provision of the following services would impair the auditor's independence:

a. Compute derivative values using either auditor or client-provided assumptions and a firm-developed, or third party model approved by the client.

b. Develop or be responsible for key assumptions or inputs for use by the client when it uses any valuation model or product.

c. Provide a firm-developed, non-standardized model (e.g., black box equivalent) which a client uses to value its derivatives. The model's methodology or formulas are not standardized, or assumptions are built into the model such that values produced may differ significantly from those produced by another vendor's models.

14. As mentioned above, the overarching principles underlying this interpretation are that the auditor cannot be placed in the position of "auditing his or her own work," or accepting responsibility for the choices and judgments inherent in the preparation of the financial statements such that the auditor is acting as a member of management.

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