

# Alert

January 2004

## Responsible Corporate Governance Significantly Impacts Valuation Review

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In the wake of corporate scandals and the subsequent passing of the Sarbanes-Oxley Act, more companies are implementing measures to ensure responsible corporate governance. Concerned about independence and conflicts of interests, many companies have chosen to engage outside specialists for non-audit services, such as valuation work. Sarbanes-Oxley precludes audit firms from providing valuation services to audit clients if the results of the service are material to the financial statements and the service involves a high degree of subjectivity. Prohibited services include valuations for allocation of purchase price (SFAS 141) and goodwill (SFAS 142), as well as valuations of stock options.

### USING THE WORK OF A SPECIALIST

The requirements for working with a specialist are outlined in Statement on Auditing Standards (SAS) No. 73, *Using the Work of a Specialist*. SAS No. 73 applies when management or an auditor engages a specialist and the auditor uses the specialist's work as evidence in evaluating financial statements. The guidance in SAS No. 73 applies to audits of financial statements prepared in accordance with generally accepted accounting principles (GAAP). Although SAS No. 73 has been around for years, recently auditors have been feeling more pressure from the SEC to adhere to the Statement. The main requirements of SAS No. 73 include the following:

1. **Qualifications and work of a specialist.** The auditor has to evaluate the qualifications of the specialist to determine if the specialist has the required skills or knowledge in a particular field. The auditor also has to understand the nature of the work which will be performed by the specialist.
2. **Relationship of the specialist to the client.** The auditor should assess the relationship of the specialist to the client, including factors that may impair the specialist's objectivity.
3. **Using the findings of the specialist.** The auditor normally would use the work of the specialist unless the auditor believes the findings are unreasonable. In that case, the auditor should apply additional procedures, such as obtaining the opinion of another specialist.

### SAS No. 101

When management hires an independent valuation specialist, the company's auditor is responsible for obtaining evidence to provide reasonable assurance that the stated fair values conform to generally accepted accounting principles (GAAP). The auditor should become familiar with the concept of value and the methodologies used by valuation specialists.

The Statement on Auditing Standards (SAS) No. 101, *Auditing Fair Value Measurements and Disclosures* provides general guidance to auditors for auditing fair value measurements.

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According to para. 38 of SAS No. 101:

*"For items valued by the entity using a valuation model, the auditor does not function as an appraiser and is not expected to substitute his or her judgment for that of the entity's management. Rather, the auditor reviews the model and evaluates whether the assumptions used are reasonable and the model is appropriate considering the entity's circumstances. For example, it may be inappropriate to use discounted cash flows for valuing an equity investment in a start-up enterprise if there are no current revenues on which to base the forecast of future earnings or cash flows."*

*"In the current climate of corporate governance, management, auditors and valuation specialists are being held to a new level of accountability."*

SAS No. 101 states that auditing procedures should typically focus on the following:

- 1. Evaluating the significant assumptions.** The auditor must consider whether the assumptions are reasonable and consistent with existing market information, the economic environment and past experience.
- 2. Determining whether the valuation model is appropriate.** The auditor should review the model and decide whether it is appropriate in the circumstances.
- 3. Testing the data behind the fair value measurement.** The auditor evaluates whether the data is accurate, complete, and relevant.

It is important to note that the above is a brief discussion of the key points contained in SAS No. 73 and SAS No. 101. A thorough review of both Statements is recommended.

### NEW LEVEL OF ACCOUNTABILITY

For years auditors have depended on opinions of value supplied by valuation specialists. With the current focus on independence and avoiding conflicts of interests, engaging a valuation professional for valuation services is advisable. However, the use of a specialist does not allow the auditor to delegate his or her responsibilities. Auditors need to have an in-depth understanding of the approaches and assumptions used by valuation professionals.

The valuation industry has experienced a significant increase in time allocated to auditors in the review process. In many instances, client management is also an active participant in the review. All involved parties should recognize that a more thorough review process provides a greater degree of comfort and assurance against any perceived conflict of interest. In the current climate of corporate governance, management, auditors, and valuation specialists are all being held to a new level of accountability. For more information regarding valuations, contact your Valuation Research representative or William Hughes at 630/990-2626. **VR**

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