The subjectivistic measurement of fair market value and financial record estimates has frustrated auditors of all sizes, prompting the Public Company Accounting Oversight Board in the United States to seek input on the question, but experts wonder whether the board’s recent staff consultation paper can resolve the long-simmering debate.

“Auditors don’t particularly like fair value measurements because it’s very, very hard to audit. You’re basically auditing assumptions, and that’s a thankless task,” said Susan Scholz, a professor of accounting at the University of Kansas’ School of Business. “It’s been an ongoing issue for as long as I can remember. And I don’t know how you’re ever going to get really strong fair value estimates to the degree that investors say they want them with any certainty of getting reliable information.”

Over the past several decades, the accounting debate has ranged pitting relevance versus reliability, which creates an inherent tradeoff. Historical costs are reliable because those numbers are known. But they may not be as relevant as market values which are, in turn, less reliable.

“It’s a tradeoff of reliability. There is a direct impact with the reliability, which creates an inherent tradeoff,” said W. Robert Knechel, director of the International Center for Research in Accounting and Auditing at the University of Florida.

The PCAOB report said deficiencies have been discovered in multiple audit areas, including the allowance for doubtful accounts or loan losses, goodwill and intangible asset impairment, inventory valuation allowances, and income tax valuation allowances.

“Auditing accounting estimates and fair value measurements have proven challenging to auditors. Over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosures and disclosure requirements. Through its oversight activities, the PCAOB has observed significant audit deficiencies in this area,” the audit watchdog’s report said.

“The biggest problem is fundamentally that these areas of audit are subject to the most judgment,” said Knechel. “The reality is when you’re talking about bad debts, for example, management has a number. The auditor comes up with a number, and the only thing you can say for certain is that’s the number because they’re completely dependent upon future events.”

“There’s no way to know which customers are going to pay [or] are not going to pay,” he added, noting than unforeseen economic factors could also change the outlook.

Scholz said unless one is looking at the price of a traded stock, or something else with a readily available market price, estimating fair value can be very tricky.

“There’s the old tradeoff between ‘do you want to put something on your books that is very hard to validate and probably will be wrong?’ Or do you want to leave it as an historical cost or some other cost that you absolutely know is wrong [in terms of its present value]?” she asked.

Investors probably prefer to have the fair value, which would be great information to possess if it was possible to ascertain exactly. Given the difficulty to measure fair value, investors need to question whether they are satisfied with an estimate, Scholz said.

“The nature of a fair value estimate is that you’re ultimately going to be off by something. [So] there are a lot of people that would prefer to have the certainty of historical cost, where they normally know.”

It means “this is what we paid for it and we know that it is not the current value,” she said.

Whether fair market value itself is really current is another question.

“Nothing I’ve always found interesting about this movement to fair value is that we put a ton of effort into nailing down these fair values at Dec. 31 or whatever the fiscal-year-end is,” said Knechel. “But the reality is nobody actually sees numbers until late February. By the time anybody outside the company sees those numbers, they’re all different. Everything in the markets can change in the six weeks it takes to generate the financial statements.”

Another key question, in cases where historical cost is used, concerns whether information on the financial statements is still going to be reliable. “In certain circumstances, at least, the answer appears to be a decisive no. For example, under U.S. GAAP, property, plant and equipment (PP&E) must normally be measured at historical cost, but if the firm is purchased by another company that will require estimating the fair value of all PP&Es.

A further complicating factor today involves the growth of complex instruments such as derivatives. “Many companies don’t really have a lot of expertise in valuing some of these instruments or using them, and yet everybody is valuing with them,” said Scholz.

The PCAOB report also addressed this issue.

“The complex nature of some financial instruments creates challenges in determining their value, which can be based primarily on unobservable inputs not corroborated by market data,” it said. “As a result, many companies and auditors use third parties, including pricing services, to obtain information relevant to determining and auditing the fair values of financial instruments, which may or may not be developed using unobservable inputs.”

Fair value is most often found in derivative instruments and pension plans, and therefore can be a big issue only with private companies but also government pension plans, said Scholz.

“Inventories is supposed to be at the lower of cost or market. So that’s not really a fair value measure unless the fair value drops below what you pay for it. Then you have to do an estimate. If assets seem to be impaired in some way then you’ve had to estimate the fair value of it,” said Scholz.

“I think one of the things that really concerns people is that some assets or some liabilities are [expressed at] historical cost and some are fair value, and people using the financial statements don’t really understand exactly what the valuation is when they look at it.”

The PCAOB are said to be examining whether audit procedures tailored to the source of information used by the auditor are appropriate for developing an independent estimate.

They have asked for responses to suggested alternative approaches that include the PCAOB issuing additional staff guidance specific to the use of third parties, such as pricing services. They are also considering developing a separate standard on auditing fair value of financial instruments, in addition to existing standards covering auditing fair value measurements and derivatives and securities.

A further possibility is to enhance existing standards on auditing accounting estimates and fair-value measurements through targeted amendments, rather than replacing existing standards. A fourth alternative is to issue a new single standard that will address auditing of accounting estimates and fair-value measurements and supersede existing standards.

Knechel likes the final option.

“If you want to send a message to the practice of auditing that would have the strongest effect, [with] a whole new standard you’re going to have to put all your people through a formal program requiring everyone to undertake new continuing education. I think that [says] ‘while I think the standards in the past were not so bad, maybe the implementation hasn’t all it should have been,’ ” said Knechel.

The deadline for submissions to the PCAOB on its staff consultation paper is Nov. 3.