RELEVANT TO ACCA QUALIFICATION PAPER P7

Studying Paper P7?
Performance objectives 17 and 18 are relevant to this exam

AUDIT OF ESTIMATES AND FAIR VALUES

Making estimates is an inevitable part of preparing financial statements. Management will need to make estimates about many of the assets and some of the liabilities in order to show them at a reliable value. These estimates will include some routine matters such as the expected life of property, plant and equipment, estimating appropriate allowances for receivables and some more challenging matters, such as valuation of pension liabilities for a newly acquired subsidiary. Estimates share one characteristic above all others – they are an attempt to look into the future and are consequently subject to a high degree of uncertainty and so inherent risk of misstatement.

ISA 700 requires that an auditor expresses an opinion in terms of reasonable assurance. This requires us to state an opinion that we believe a set of financial statements present a true and fair view (or are fairly presented). The assertive nature of this opinion requires a substantial amount of robust evidence to support it. It is rather too easy to drop into auditing estimates to a degree where conclusions become that management's estimates are 'reasonable' or even 'plausible'. Neither of these conclusions mirror the wording used in our actual audit report and so are insufficient to comply with the requirement of ISA 700 and ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Obtaining certainty about the future is impossible, but obtaining evidence to support a reasonable conclusion on likely future outcomes is not.

How can estimates be wrong?

It is logically impossible to say that an estimate about the future is certain to be right. It's much easier, however, to identify when an estimate is likely to be wrong. So it is perhaps easiest to start off identifying some common situations when an estimate looks likely to be materially misstated. This list isn't exhaustive, but it includes some of the biggest potential errors and you should be sure that you're comfortable with all of them before taking the Paper P7 exam.

Misunderstanding the stated system of GAAP. In the audit report, we define true and fair, or fair presentation, by referring to full compliance with a stated system of GAAP. It is, therefore, essential to have an in-depth knowledge of the GAAP system being used to define truth and fairness before it's possible to express an audit opinion that is built on that system. This is why you can expect a reasonable amount of accounting knowledge to be needed to pass Paper P7.

Unfortunately, there is not one unifying method of deciding what constitutes a true and fair estimate. For example, inventory will be defined as being fairly estimated in value if it is valued at the lower of cost and net realisable value. Contingent liabilities are fairly estimated if they are shown with a value of zero, unless they are being valued as part of an acquirer's initial consolidation of a new subsidiary (see later). The definition of fair value given in the IASB glossary is: The amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. In practice, this definition is stretched somewhat depending on the asset or liability in question and so it is necessary to know the specific rules for each material asset or liability.

Management bias. Bias is not necessarily deliberate, but is almost certain to exist in most estimates. Bias may be exacerbated during a takeover situation, when management are likely to wish to convince sellers of a business that net assets have a lower fair value than they really have, in order to obtain a lower price for the acquired business. Innate optimism and human nature may deter management from wishing to accept that less will be received from receivables than management wish. Familiarity with preparing estimates in an established way may also build in long-standing bias.

Poor data, poor controls. If information systems are poor, even neutral management will produce estimates that are unreliable. For example, if a loan provider has poor data collection on overdue repayments, estimates of impairments of financial assets are likely to be unreliable.

Fair values – acquisition of new subsidiaries

When a parent company acquires a new subsidiary, it will pay the fair value of the acquired company as a whole. This is because the previous owners tend to be unwilling to sell their company for less than its fair value. In order to bring in a fair estimate of the initial value of goodwill, IFRS 3, *Business Combinations* requires that the individual net assets of the acquired company be valued at their fair value at the date of the acquisition. Fair value still means the amount that would be transferred between knowledgeable parties in an arm's length transaction. Often, the acquirer will have investigated their assessment of value of material assets, liabilities and contingent liabilities of the target company as part of a pre-acquisition due diligence investigation. In these circumstances, the values ascribed to individual assets and liabilities in this due diligence will be an appropriate value to use for the initial recognition of each asset and liability. This means that fair value often becomes fair value through the eyes of the acquirer. This is not always the most appropriate valuation basis, however, since the value given by the acquirer may include some degree of the acquirer's intentions. For example, it is common for a new acquirer to plan to restructure an acquired business shortly after the acquisition. This might include an intention to pay off any litigation in progress at the date of acquisition in order to fee management time for integration of the subsidiary into its new group. This could result in incorrect recognition of provisions that are higher than the true value of the obligation.

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets* normally prohibits recognition of contingent liabilities. This rule is overturned on the acquisition of a new subsidiary, since the existence of contingent liabilities (eg individual lawsuits against the company) will reduce the value that the acquirer is willing to pay for control of the company. To ensure a fair value of initial goodwill, contingent liabilities must be valued within the statement of financial position; with the most appropriate valuation probably being the amount that the acquirer would be willing to pay an independent third party to assume the risk on their behalf.

IFRS 3 also requires recognition of any contingent consideration payable to the sellers of the new subsidiary. These are common in 'earn out' arrangements where the amount that the seller eventually pays is adjusted for post-acquisition profit of the business. The determination of a fair value of this contingent consideration is subject to elevated estimation uncertainty.

What is the auditor to do?
ISA 540 states that the auditor's objective is to obtain sufficient, appropriate evidence on whether:

- Accounting estimates are reasonable, and
- Related disclosures in the financial statements are adequate.

A critical first step for the auditor in planning the work needed on estimates is to understand the client's business and identify where the greatest scope for accidental or deliberate bias in production of estimates exists.
This assessment will include a formal and documented assessment of:

- How the client identifies items subject to estimates and how satisfactory these procedures appear to be.
- How the client identifies and assesses *estimation uncertainty*. Estimation uncertainty is 'The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement'. The greater the estimation uncertainty, the more the client will need to explore the effect of different models

and assumptions to make an appropriate estimate. For example, if long-term receivables are judged to be subject to high estimation uncertainty, the client will need to test how sensitive the estimates are to changes in discount rates or assumed default rates. If estimation uncertainty is lower, less work will be required by the client in determining the estimate and also less corroborative evidence needs to be obtained by the auditor.
- How the client has identified new items that are subject to estimates and any existing items subject to estimation but where there may now be a more reliable method of establishing an estimate.
- The source data used by the client upon which to base an estimate, together with how relevant and reliable that source data appears to be.

Historically, estimates have arguably mostly been audited by assessing the client’s schedules and determining if they are reasonable. ISA 540 requires a more forensic approach than this.

Sufficient, appropriate evidence
The greater the potential materiality of an item and the greater its estimation uncertainty, the greater the evidence will need to be in order to be sufficient and appropriate to base a conclusion.
The core evidence is likely to be:
- The auditor must assess and document their own independent assessment of estimation uncertainty for each material, subjectively valued item in the financial statements.
- Assessment of adequacy of controls over determining estimates and whether the controls have worked as specified. For example, if a risk management committee is tasked with approval of all material estimates, is there evidence that this has happened, that its members were properly briefed and competent?
- Inspection of accounting policies used by management to ensure that they comply with the appropriate rules of the GAAP system used.
- Investigation of outcomes of the uncertainties after the year-end but before the audit opinion is issued. If the uncertainty has been settled before the audit opinion has been issued, the uncertainty has effectively been disposed of.
- Comparison of historical accuracy of management estimates compared with actual outcomes. The greater the variance between estimates and eventual outcomes, the greater the risk of error; either by high estimation uncertainty or weak control by management of the process of determining estimates.
- Verification of any underlying data used by management (eg debt default rates by age of debt) to external evidence.

- The auditor's response is graded depending on whether a risk identified is a normal risk or a significant risk. A significant risk is one that the auditor judges to have high estimation uncertainty. The size of the item in the draft financial statements may give a misleading view of its potential significance. If an item is estimated to have a low value, but is subject to high estimation uncertainty then that figure may well be significantly understated when compared with the eventual outcome of the estimate. Hence ISA 540 directs the auditor's work from a starting point of uncertainty rather than the materiality of the draft figure in the financial statements. The greater the estimation uncertainty, rather than the size of the draft figure, the greater the amount of evidence that the auditor will need to obtain.
- The auditor must develop their own point estimate, or range of estimates if a point estimate is not achievable. A point estimate is the auditor's own assessment of the single most likely value. A range of estimates is the range over which the auditor believes an estimate would be reasonable.
- For significant risks, the auditor must assess if management considered alternative means for determining estimates.
- Significant risks may arise as a result of valuation being largely linked to management intentions (eg the intended future use of an asset may affect its recoverable value and so impairment loss under IAS 36, *Impairment of Assets*). ISA 540 requires the auditor to document an assessment of viability of management's intentions wherever these intentions are part of the estimated fair value of an item subject to significant risks.
- The auditor must assess for signs of management bias. The existence of management bias does not necessarily mean that management is incapable of producing a neutral estimate, but the chances of an estimate not being neutral are increased.
- A change in method of estimation by management should be treated with scepticism. Changing the methodology used to make an estimate has much the same effect on the financial statements as changing an accounting policy, so the auditor should require evidence that a change in methodology as necessary to produce more reliable estimates.
- Sceptically review assumptions used by management for internal consistency and ensure in accordance with observable market data. For example, if inflation has been built into growth in expected income streams, ensure that all future costs are also estimated allowing for expected inflation. There is a high inherent risk of cost estimates being based on today's costs; thus overestimating net income.
- Ranges of estimates are normally adequate if their range of values (other than remotely possible values) is within

performance materiality. Performance materiality is the figure below which errors noted on audit tests of detail are not cumulatively recorded in the audit files. If their range of values other than remote possibilities falls outside the limit of performance materiality, they represent significant estimation risks and more evidence is required; normally including estimation of a point estimate.
- Should consider need for specialist advice.
- Obtain written management representations to confirm the auditor's understanding of management's intentions. Note that management representations alone do not provide sufficient, appropriate evidence. The representation letter should be viewed as a necessary, but insufficient component of the audit evidence.

Summary
Audit of estimates is subject to a high degree of uncertainty. The degree of audit risk is somewhat reduced by GAAP systems accepting that more than one estimate of the same uncertainty may give a true and fair view. This is why GAAP systems often require substantial disclosure of the circumstances giving rise to the uncertainty; so that readers can make up their own mind.

Audit of estimates is likely to be a common feature in the Paper P7 exam, as well as in practice. Auditor's judgment is often difficult to challenge. Failure to follow the prescribed steps that lead to the use of auditor's judgment however is much easier to attack in any negligence action. Both Paper P7 students and auditors in practice will do well to be familiar with the enhanced requirements of ISA 540.

Graham Fairclough is group technical director at the ExP Group