PART II –AUDITING A PURCHASE PRICE ALLOCATION

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INTRODUCTION

- Fair Value estimates differ from those for other accounting applications
- They are an "approximation of a monetary amount in the absence of a precise means of measurement"
- When market prices are not available management must apply a suitable methodology using assumptions that other participants in the same marketplace would make

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INTRODUCTION

- This unique aspect is combined with a large number of accounting standards that require Fair Value
- The complexity of some of these measurements and their significance to Financial Statements requires specific auditing techniques
- These comments are based mainly on US practice but should be applicable elsewhere

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INTRODUCTION

- With respect to a Fair Value estimate it is essential for the auditor to:
  - Obtain sufficient competent audit evidence to provide reasonable assurance that Fair Value measurements and disclosures conform to the relevant standards
  - Understand the processes for determining Fair Value and the applicable controls in sufficient detail to develop an effective audit procedures

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INTRODUCTION

- Evaluate management's intent & ability to carry out specific courses of action relevant to the determination of Fair Value including
- presentations, disclosures and changes in Fair Values reported in the Financial Statements
- Confirm the methods of measurement are appropriate when there are no observable market prices and that they are applied consistently

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INTRODUCTION

- The following items are particularly important:
  - Fair Value estimates are expressed as the value of a current transaction or fnancial statement item based on conditions prevalent at the measurement date
  - They incorporate judgments and significant assumptions by others, such as experts, engaged by the entity or the auditor

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INTRODUCTION

- The availability of information or evidence may be limited and so its reliability
- The range of assets and liabilities for which fair value is being estimated
- The choice and sophistication of acceptable valuation techniques and models

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INTRODUCTION

- The need for appropriate disclosures about measurement methods and uncertainties, especially when relevant markets are illiquid, otherwise limited or even do not exist

INTRODUCTION

- The nature and reliability of information available to management to support its fair value accounting estimate vary widely
- There are various degrees of uncertainty associated with these estimates
- Where markets are inactive, price information becomes unavailable

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INTRODUCTION

- Estimates need to be made on the basis of other information, often using models
- Some incorporate inputs that are "unobservable"
- The degree of uncertainty increases as does the risks of material misstatement
- A routine valuation problem may become the source of a signifcant risk

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INTRODUCTION

- Whether inputs are observable or not, preparers need evidence to support them
- Auditors need sufficient appropriate information
- Recognize that this may be different from what has previously been available
- Fair Values are commonly thought to relate primarily to financial assets and liabilities

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INTRODUCTION

- However, as shown in Part 1, they are more widespread
- Fair value measurements of assets, liabilities and components of equity are required for both the initial recording of transactions, later changes & impairment testing

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INTRODUCTION

- Financial instruments and other assets recorded at historical cost , but not required to be re-measured at fair value, may nevertheless require fair value consideration, depending on the financial reporting framework, for supplementary disclosure or for estimation of provisions or impairment losses

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INTRODUCTION

- Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks
- Some frameworks may require that changes be reflected directly in equity, while others have them reflected in income

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INTRODUCTION

- An Auditor has an overarching requirement to obtain sufficient appropriate audit evidence to ensure that Fair Value measurements and disclosures are in accordance with the applicable financial reporting framework

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INTRODUCTION

- The International Standards for Auditing (IAS) 545 is the principal guidance for Fair Value measurements
- Additional requirements relate to
  - Assessing the risks of material misstatement
  - Responding to assessed risks
  - Using the work of an expert

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INTRODUCTION

- Consider whether to engage a specialist and use his work as evidential matter in performing tests to evaluate material financial statement assertions
- Determine that the audit committee is informed about the process used by management in formulating sensitive accounting estimates, including those for Fair Values and the basis for management's conclusions regarding their reasonableness

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TESTING PROCESS

- Management is responsible for all the Fair Value measurements and disclosures
  - It should establish processes to determine appropriate Fair Values
  - Select suitable valuation methods
  - Identify and adequately support all significant assumptions

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TESTING PROCESS

- Prepare any necessary reports
- Ensure that presentations and disclosures are in accordance with the relevant IFRS

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TESTING PROCESS

- The Auditor's substantive examination of Fair Values should involve
  - (a) testing management's significant assumptions, the valuation model and the underlying data
  - (b) developing independent Fair Value estimates for corroborative purposes
  - (c) examining subsequent events or transactions that confirm or negate the estimates

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TESTING PROCESS

- In step (a) the Auditor must determine whether
  - Management’s assumptions are reasonable and reflect, or at a minimum are not inconsistent with any available market information
  - The Fair Value measurements were established utilizing appropriate techniques, methods and models

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TESTING PROCESS

- Management took into account all relevant information reasonably available at the time
- This process is required even when the actual Fair Value estimate is made by an outside Valuator
- The Auditor must satisfy himself as to the Valuator's qualifications
- Determine that he has the necessary skills and knowledge

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TESTING PROCESS

- Fair Values for Financial Statements require skills not needed for other types of valuations
- Even though management may use a qualified and objective specialist, it is still wholly responsible for the Fair Value measurements
- After the Auditor is satisfied with the qualifications of the Valuator

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NATURE OF WORK

- He needs to understand the nature of the work performed
- This will normally require him to
  - Understand its objective and scope
  - Determine that the Valuator understands the relevant definition of Fair Value and how it relates to various specific items

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NATURE OF WORK

- Consider the methods and significant assumptions used for each asset, liability or contingency
- Look at the reliability of the sources of all non-client data

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NATURE OF WORK

- Identify the data from the client so that it can be subjected to audit testing
- Compare the current methods and significant assumptions with those used in valuing its assets previously

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NATURE OF WORK

- Evaluate any restrictions on the Valuator's access to necessary personnel, records or files
- Confirm the Valuator's understands that his Report(s) will be used to support the related assertions in the Financial Statements

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NATURE OF WORK

- inquire as to the anticipated availability of the written Report(s)
- identify issues that might affect the timely recording and auditing of the Fair Values
- inform the Valuator of all the specific items needed to support the auditor's planned procedures
- Ensure they are included in the Reports

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NATURE OF WORK

- The Valuator should make this task as easy as possible for the Auditor by fully documenting
  - Methodologies selected
  - Models chosen
  - Assumptions adopted
  - Data relied on in the Reports

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CONFORMITY WITH IFRS

- The Auditor must ensure that the Fair Value measurements, presentations and disclosures are in conformity with the relevant IFRS based on
  - Understanding of their requirements
  - Knowledge of the businesses and the industries in which they operate

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CONFORMITY WITH IFRS

- Results of audit procedures performed to test the Fair Values
- Application of other suitable audit procedures
- Have a level of knowledge of the entity's business to plan and perform an audit in accordance with auditing standards

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KNOWLEDGE OF THE BUSINESS

- Sufficiently understand all events, transactions and practices that may have a significant effect on the Financial Statements
- Have a similar knowledge of events, transactions and practices affecting the Fair Values of any asset, liability or contingency

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KNOWLEDGE OF THE BUSINESS

- This should include, for example
  - Types of products and services sold
  - Production, marketing, distribution and compensation methods

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KNOWLEDGE OF THE BUSINESS

Trends affecting the industries

- economic conditions
- changes in technology
- government regulation
- competitive conditions
- current and potential competitors to the extent they effect the Fair Values of the assets or liabilities of the Financial Statements

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KNOWLEDGE OF THE BUSINESS

- If he has not obtained this level of understanding in his normal work meet with
  - Chief Executive Officer
  - Chief Financial Officer

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KNOWLEDGE OF THE BUSINESS

- Representatives of the Target and Acquirer's
  - Marketing
  - Business development
  - Production
  - Research & development
  - Technology department

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KNOWLEDGE OF THE BUSINESS

- Obtain information about the following
  - Customers
  - Markets served by the entity and those it would like to serve
  - Competitive conditions
  - Regulatory requirements
  - Sensitivity to economic conditions

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KNOWLEDGE OF THE BUSINESS

- Product or service line(s)
- Historical and existing product life cycles
- Changes in volumes and average selling prices over the life cycles
- Manufacturing capacities
- Distribution capabilities
- Management team

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KNOWLEDGE OF THE BUSINESS

- Base (or core) technologies
- Future products and their dependence on base (or core) technologies
- Technology development including research & development capabilities

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INTANGIBLE ASSETS

- The Reports should describe the processes used to identify all intangible assets, acquired or internally generated
- The Auditor, based on his knowledge of the entities, the industry and the particular acquisition should consider whether there are other intangibles

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INTANGIBLE ASSETS

- Review items in IFRS 3 with management and, if necessary, the Valuator to establish
  - Did any additional intangible assets exist at the acquisition date

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PLANNING THE AUDIT

- When planning the engagement the Auditor will assess the risk of material misstatement from error or fraud

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PLANNING THE AUDIT

- Risks of material misstatement of Fair Values of assets or liabilities depend on the reliability of management's processes
- These depend on the degree of uncertainty of the underlying projections of cash flows

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PLANNING THE AUDIT

- These may be as a result of the following
  - length of the forecast period
  - number of significant and complex assumptions involved
  - degree of subjectivity associated with the assumptions and factors selected
  - uncertainty associated with the future occurrences or outcomes of events underlying the assumptions
  - lack of objective data

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PLANNING THE AUDIT

- In obtaining an understanding of the entity's processes the Auditor should inquire about the
  - controls over the processes including underlying data
  - relationships between the individuals approving a Business Combination
  - expertise and experience of those responsible for determining the Fair Values

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PLANNING THE AUDIT

- role that information technology plays in the valuation processes
- items requiring Fair Value measurements arising from routine and recurring events
- non-routine or unusual transactions
- extent the entity relies on outside specialists to provide Fair Values or supporting data

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PLANNING THE AUDIT

- significant assumptions selected by management
- documentation supporting management's choices
- processes to develop and apply assumptions, including the extent to which market information was used

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PLANNING THE AUDIT

- steps taken to monitor changes in the assumptions adopted
- integrity of change controls and security procedures for valuation models and information systems
- including approval processes
- controls over the consistency, timeliness and reliability of the data used

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PLANNING THE AUDIT

- Reflecting on his understanding of the entity's reporting processes, the Auditor assesses any control risks by evaluating the reliability of internal controls in designing substantive tests
- The Auditor determines the nature, timing and extent of the necessary procedures
- The Valuator must be aware of an Auditor's "show me" attitude and have appropriate controls in place for all Financial Statement valuations

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PLANNING THE AUDIT

- Estimating Fair Values often involves subjective judgments by both management and Valuators
- This may affect which controls are implemented
- It increases the possibility of management overriding them

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TESTING UNDERLYING DATA

- The Valuator must be aware that meeting external future earnings expectations can give management incentives to misstate some Fair Values

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TESTING UNDERLYING DATA

- When auditing Fair Values and a PPA, the Auditor will design and perform substantive procedures to establish
  - Every tangible and intangible asset acquired and liability assumed has been identified and a portion of the purchase price allocated to it
  - The valuation methods used are appropriate

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TESTING UNDERLYING DATA

- To the extent possible, the Valuator should
  - prepare his file in sufficient detail to satisfy the auditors' requirements under the various applicable standards
  - document in the work papers the methods and assumptions selected and why each choice was made

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SIGNIFICANT ASSUMPTIONS

- Management, with the assistance of the Valuator, is responsible for identifying the significant assumptions underlying the Fair Values
- Generally, significant assumptions are those that
  - materially affect conclusions
  - are by nature sensitive to variation or uncertainty in amount
  - susceptible to misapplication or bias

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SIGNIFICANT ASSUMPTIONS

- Assumptions are an integral component of all valuation methods
- The Auditor will test the significant assumptions used to determine whether they are reasonable and are not inconsistent with market information

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SIGNIFICANT ASSUMPTIONS

- The objective is not to obtain sufficient competent evidence to provide an opinion on the assumptions themselves
- but to evaluate them as supplying a reasonable basis for measuring Fair Values in the context of the Financial Statements as a whole

SIGNIFICANT ASSUMPTIONS

- The Auditor will consider the sensitivity of the Fair Values to changes in significant assumptions, including market conditions
- Management should identify particularly sensitive assumptions
- If management has not done so, the Auditor will likely employ sensitivity analyses or Monte Carlo simulations to identify such items

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SIGNIFICANT ASSUMPTIONS

- In evaluating the reasonableness of the significant assumptions, the auditor will consider whether individually and, taken as whole, they are realistic and consistent with:
  - general economic conditions
  - outlook for specific industries
  - entity's existing and expected situations
  - available market information

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SIGNIFICANT ASSUMPTIONS

- approved budgets and plans of the entity
- management's expectations as to the outcome of specific objectives and strategies
- assumptions made in prior periods, if appropriate
- past experience of, or previous conditions experienced by the entity
- assumptions used by management in other accounting estimates

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SIGNIFICANT ASSUMPTIONS

- risks involved and their reflection in the related discount rates
- potential variability in the amount and timing of the cash flows
- appropriateness of the Valuation Model used

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UNDERLYING DATA

- Finally the Auditor will consider whether
  - data on which the Fair Values are based is accurate, complete and relevant
  - whether the Fair Values obtained have been properly determined using such data and management's selected assumptions

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UNDERLYING DATA

- Procedures and tests undertaken may include
  - verifying the sources of the data
  - mathematically confirming inputs
  - reviewing information for internal consistency
  - management's intent and ability to carry out specific courses of action

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UNDERLYING DATA

- The nature, timing and extent of the Auditor's procedures depends upon the susceptibility to misstatement of a Fair Value measurement
- The Auditor uses the understandings discussed above to design and implement responses to the risks of material misstatement

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INVESTMENTS

- Factors that may influence the Auditor's risk assessment re investments, include whether
- The entity has control procedures in place for making investment decisions, including whether theses decisions are communicated with those charged with governance

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INVESTMENTS

- He believes management has undertaken sufficient due diligence to evaluate the risks that may arise from any security before investing it
- Those responsible for making investment decisions have sufficient expertise

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INVESTMENTS

- The entity has the ability to subsequently value the securities
- Confirmation that there is appropriate segregation of duties between those responsible for making investments and those involved in determining their value
- Management has a satisfactory track record in assessing the risks of particular investments

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INVESTMENTS

- The reliability of audit evidence is influenced by its source and nature
- Management may use a broker's quote to support a Fair value
- A quote from the organization that initially sold the instrument, this evidence is less objective
- It may need to be supplemented from one or more other sources

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INVESTMENTS

- Pricing services and brokers may use methods that are not known to management
- The Auditor may need to obtain an understanding of how such information was developed
- Based on private trades, results of a cash flow model and some combination of inputs

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INVESTMENTS

- Such inquiry into the nature of a broker's quote is directed at its reliability and consistency with the objective of Fair Value
- Changes in markets may require changes in valuation methods
- Consistency is generally a desirable quality in financial information, but may be inappropriate if circumstances change

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INVESTMENTS

- The introduction of an active market is a changed circumstance leading to a move from a cash flow valuation to a market price
- In the current environment such changes are in the opposite direction
- Even where models have been consistently used there is a need to examine the continuing appropriateness of analyses and assumptions

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INVESTMENTS

- Consequently, the degree of consistency of valuation methods and the appropriateness of changes in assumptions require audit attention
- A change in valuation method does not alter the underlying measurement objective for Fair Value as defined in the financial reporting framework, to some ‘intrinsic’ or ‘fundamental’ value

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INVESTMENTS

- ISA 500 provides guidance on
  - What constitutes audit evidence
  - The quantity and quality to be obtained
  - Audit procedures

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CONCLUSION

- Evidence about assumptions and the validity of models is necessarily less reliable than prices taken from an active market
- It is necessary to look at more sources
- Accumulate sufficient appropriate audit evidence
- The quantity needed is affected by the greater risk, the more required

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