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Audit Requirements and Standards

Analysts performing valuations for financial reporting purposes are likely to be subject to audit procedures by the subject company’s auditors. As such, assessing the sufficiency of the analyst’s procedures and documentation requires an understanding of the applicable auditing standards.

There are different auditing standards that may be applicable in different circumstances, but it is likely that the two most common sets of standards an analyst will encounter are: 1) Auditing Standards issue by the Public Company Accounting Oversight Board (PCAOB) and 2) International Standards on Auditing Issued by the International Auditing and Assurance Standards Board (IAASB).

Generally speaking, the purpose of an audit is to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor’s report on management’s financial statements. Analysts performing valuations for financial reporting should be prepared to provide support and documentation of their conclusion of value and the inputs, assumptions, and judgments that led to that conclusion.

Extent of Audit Procedures

The extent of procedures performed by auditors varies depending on the size and nature of the fair value estimate and the materiality levels for the audit. Analysts should avoid making valuation judgments based on their own assessment of materiality. If the analyst believes their analysis should be limited or altered because of materiality considerations, it should be discussed with and agreed to by the company’s auditors.

Generally, auditors will focus on key factors and assumptions that are:
1. Significant to the value estimate
2. Sensitive to variation
3. Deviations from historical patterns
4. Subject and susceptible to misstatement and bias

If a fair value estimate is considered material to the audit, the auditors will generally use one or more of the following approaches in their audit:
1. Review and test the process used to develop the value estimate.
2. Develop an independent estimate to corroborate the reasonableness of the value estimate.
3. Review subsequent events or transactions occurring prior to the date of the auditor’s report.

The consideration of subsequent events is an area where audit standards differ significantly from valuation standards. Auditors can consider subsequent events whereas valuation standards generally prohibit the consideration of events that were not known or knowable at the valuation date. Although it may be reasonable for the analyst to not consider subsequent events or transactions, the analyst should be aware of such transactions and be prepared to answer questions about the magnitude of the difference in value (if any) and the causes for that difference.
Assessing Qualifications and Work of a Specialist

When management has engaged a specialist, the auditor will generally perform the following procedures:

1. Assess the knowledge, skill, and ability of the specialist, including whether the specialist has any relevant certifications, licenses, or accreditations, their reputation and standing in their field, and the extent of the specialist’s experience in the type of work performed.

2. Assess the specialist’s relationship with the subject company to determine whether the subject company had the ability to significantly affect the specialist’s judgments about the work performed, conclusions, or findings.

3. Evaluate the specialist’s work, including the accuracy and completeness of the data used by the specialist (whether provided by management or obtained from external sources), the reasonableness of the significant assumptions and the relevant information used to develop those assumptions, and the appropriateness of the methods used by the specialist.

Certified in Entity and Intangibles Valuation Insights

Concerns on Fair Value Estimates for Financial Reporting

At various times, the U.S. Securities and Exchange Commission (SEC) has expressed concerns regarding the quality of fair value estimates developed for financial reporting. Incorrect fair value estimates will reduce the reliability of financial statements. Reduced confidence in financial information can reduce investor and other parties’ confidence in financial information and, hence, the financial markets.

In 1998, the SEC noted that incorrect valuations of in-process research and development (IPR&D) led to revisions of fair value estimates and restatements of financial statements for a number of public companies in the U.S. In 2011 and at other dates, then SEC Chief Accountant Paul Beswick’s commented on the need for continued improvements in performing and supporting valuations. The Public Company Accounting Oversight Board (PCAOB) inspections of audits of fair value estimates note concerns regarding the adequacy of an auditor’s review of the fair value estimate.

Concerns regarding fair value estimates have led to the release of technical guidance intended to improve fair value estimates. The scrutiny of IPR&D valuations resulted in the 2001 release of valuation and accounting guidance including the American Institute of Certified Public Accountants (AICPA) Practice Aid: Assets Acquired in a Business Combination to Be Used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries. This guide provided helpful technical accounting and valuation guidance to improve the quality of IPR&D valuations. Guidance in a variety of technical areas impacting business, security and intangible asset valuations have been released by The Appraisal Foundation or the AICPA.

For a discussion of these documents, see Chapter 45.

This concern about fair value estimates is especially challenging as value and valuations are often based on future results. In some cases, past results are a clear indication of the future and valuations may be somewhat less challenging. However, many fair value estimates involve companies in dynamic industries where valuations can be quite challenging.

Introduction of CEIV Designation and MPF Documents

The Certified in Entity and Intangible Valuations (CEIV) designation and the related *Mandatory Performance Framework* (MPF)\(^1\) and *Application of the Mandatory Performance Framework* (AMPF)\(^2\) documents are intended to improve valuation quality. The MPF and AMPF documents were finalized in January 2017. CEIV education and tests became available in spring 2017. The first CEIV credentials were granted to individuals at this time as well.

The CEIV credential and related procedures and the MPF and AMPF were developed by a not-for-profit entity, Corporate and Intangibles Valuation Organization, LLC (CIVO). The CIVO was created by three founding valuation professional organizations (VPOs) including the AICPA, ASA, and the Royal Institution of Chartered Surveyors (RICS). The website for the CEIV is https://ceiv-credential.org/. Information on the CEIV designation can also be obtained from the ASA website at www.appraisers.org/credentials/ceiv-certification.

The CEIV credential is intended to demonstrate an individual’s competence to develop fair value estimates for financial reporting purposes. Through this competence and expanded valuation procedures, the quality of fair value estimates is expected to improve.

The credential requirements include specialized knowledge on accounting and auditing topics relevant to preparing valuations for financial reporting. The CEIV includes performance and documentation requirements specific to fair value matters. The CEIV testing includes questions on accounting guidance, audit standards and technical releases.

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pertaining to fair value estimates. This knowledge is above and beyond the “basic” business valuation body of knowledge.

Elements of the MPF and AMPF

A key element of the CEIV process is the MPF and AMPF. (Copies of both are available free of charge at ceiv-credential.org.) The MPF and related AMPF are intended to ensure adequate valuation procedures are performed and documented. Compliance with the MPF will also enhance consistency and transparency in the performance of fair value measurements and provide a resource for the valuation review process. CEIV credential holders are required to comply with the MPF and AMPF. Compliance is viewed as a best practice for individuals that do not hold the CEIV designation.

The MPF document can be viewed more as a guide to the general process of the Mandatory Performance Framework and the AMPF provides specific performance and documentation requirements for specific technical valuation areas. Specific elements of the MPF document include:

1. Applicability of MPF
2. Overview of purpose and scope
3. Discussion of relevant valuation, accounting and auditing standards
4. Scope of the Mandatory Performance Framework – indicates that MPF covers any engagement for the valuation of a business, business interest, intangible asset, certain liabilities and inventory to serve as a basis for management’s preparation of financial statements
5. Conceptual discussion of documentation requirements
6. Professionalism and professional competence
7. Professional skepticism
8. Discussion of valuation reports
9. Glossary of terms

The AMPF document includes specific procedures and documentation requirements. Areas covered by the AMPF include:

1. General Valuation Guidance
   a. Calibration
   b. Prospective Financial Information (PFI)
2. Business Valuation Guidance
   a. Discount Rate Derivation
   b. Growth Rates
   c. Terminal Value Multiple Methods/Models
   d. Selection of, and Adjustments to, Valuation Multiples
   e. Selection of Guideline Public Companies or Comparable Company Transactions
   f. Discounts and Premiums
3. Intangible Asset, Certain Liabilities and Inventory Guidance
4. Identified Assets and Liabilities
5. Operating Rights
6. Life for Projection Period
7. Customer-related intangible assets
8. Royalty Rates
9. Contributory Asset Charges
10. Tax Amortization Benefit (TAB)
11. Reconciliation of Intangible Asset Values
12. Discounts/IRR/WARA
13. Contract Liabilities (Deferred Revenue)
14. Inventory

The AMPF requires written documentation within the engagement file that supports a final conclusion of value. The engagement file includes the valuation report and any additional work papers that document the procedures performed. Recognizing the limited users of many fair value estimates (financial statement preparer and auditor), flexibility in the degree of documentation provided in the report is allowed. Documentation can be included in the work papers.

The AMPF requires the valuation professional provide sufficient documentation within the work file to support a conclusion of value such that an experienced professional not involved in the valuation engagement could review and understand the significant inputs, analyses, and outputs and how they support the final conclusion of value.

## Composition of Valuation Documentation

Documentation is the written record within the final valuation report, supporting working papers, or both. Written documentation may include paper, electronic files, or other forms of recorded media. Examples include, but are not limited to, letters of engagement, correspondence with clients (for example, email, recordings of calls, voice messages), client-provided documents, representation letters, field notes, electronic spreadsheets, and internally prepared memoranda to the work file.

The MPF also discusses the analysis documents to include in the documentation. These generally fall into two groups:

**Computational analysis** (spreadsheets, database use). To the extent that this type of analysis provides evidential support (or contradictory indications) to an input, process, or output, they are required to be included in the work file (that is, supporting work papers, final valuation report). This analysis demonstrates “what” the valuation professional did and how they did it.

**Narrative based documents.** These documents complement the computational analyses by providing commentary on “why” the valuation professional elected certain methods, inputs, and judgments within the work-product. For example, narrative based documents could be included in:

- The narrative of the report
- The analysis documents (for example, footnotes, narrative fields)
- Memoranda to the work-file.
The MPF and AMPF documents include significant additional guidance on the valuation process and its documentation.