

An Examination of the Impact of Control Risk, Negotiation, and Pricing Specialists in the Audit of Fair Value Measurements

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Academics, businesspeople, regulators, and investors continue to vigorously argue for and against the practice of using fair value accounting. Management is responsible for developing fair value measures and disclosures that are included in the financial statements. The auditor is tasked with obtaining sufficient evidence to provide reasonable assurance the organization's fair value measures are following generally accepted accounting principles. Affecting the auditor's responsibility is the increased use of valuation specialists, the impact of negotiation during the audit, and the control risk assessment. Examining the existing research, this review provides the audit practitioner with critical insights from the existing literature and serves as a practical guide for regulators (Martin et al., 2006).

Keywords: fair value measurement, valuation specialists, audit negotiation, audit control risk

INTRODUCTION

The merits of fair value accounting continue to generate intense debates among academics, businesspeople, regulators, and investors. Many issues surrounding measuring and recognizing fair values in financial statements remain unsettled (Magnan, 2009). The increasing use of fair value accounting in financial reporting has been described as a paradigm shift. Using fair value accounting in situations where observable market-based inputs are not available, thus relying on internal estimates (i.e., calculations) is problematic (Kumarasiri & Fisher, 2011).

To properly frame the issues surrounding the audit of fair value measurements (FVMs), I investigate the explicit responsibilities of the auditor as it pertains to the audit of FVMs. Fair value changes of assets, liabilities, and equity components may result from initial transaction recording and subsequent value modifications. Management is responsible for determining FVMs and disclosures included in the financial statements. Changes in fair value may be recognized in net income or other comprehensive income as a separate component of equity. Management establishes an accounting and financial reporting process for determining fair value, which involves assumptions, judgment, and the use of published price quotations. A price quotation in an active market in isolation serves as sufficient evidence of fair value. When determining FVMs, the auditor considers the controls over the process, expertise, and role of information technology (ASB 2003, ASB 2011; PCAOB 2021b).

Auditors are responsible for verifying the accuracy of financial reports. Accounting estimates are difficult to audit as they require subjective forecasts and judgment-based modeling. Some accounting estimates involve relatively low estimation uncertainty, such as those arising in entities that engage in business activities that are not complex (ASB 2011). This causes problems for auditor judgment, which has

captured regulators' attention. Auditing standards allow various approaches to evaluating an estimate's reasonableness, and auditors overwhelmingly report using management's process for generating complex estimates. As a result, auditors may not include the recommended steps by the auditing standards, including considering whether additional factors should be included in management's model (E. E. Griffith et al., 2015).

Many estimates-based measurements, such as FVMs, are inherently inaccurate. FVMs can also be based on assumptions about future conditions, transactions, or events, the outcomes of which are unknown and thus change over time. The auditor considers such assumptions based on the information available during the audit. GAAP requires valuation methods to include assumptions that market participants would use in estimating fair value. If market assumptions are unavailable, an entity may use its assumptions. The assumptions used in FVMs are similar to those required in developing other accounting estimates. These assumptions include those made by a specialist engaged or employed by management (ASB 2003; IAASB 2003).

While management may engage the work of a specialist to substantiate their assumptions as part of deriving FVMs, the auditor might separately engage a specialist. Even when management uses a qualified and objective specialist, it cannot relinquish its responsibility for the FVM it uses. Management must determine whether the specialist has experience in FVMs and has used a fair value model consistent with GAAP (Menelaides et al., 2003; PCAOB 2021a). When an auditor plans to use a specialist's work in auditing FVMs, it should ensure that the methods used by the specialist are consistent with GAAP. FVMs may be complex and require auditors to consider factors such as the length of the forecast period, the number of significant and complex assumptions associated with the process, the subjectivity of the assumptions, and the reliance on subjective factors. The objective of the audit procedures dealing with management's assumptions is to evaluate whether the assumptions provide a reasonable basis for measuring fair values. The auditor should determine which of the company's assumptions are significant to the accounting estimate. Significant assumptions are sensitive to variation, meaning that even minor changes in the assumption can result in significant changes in the estimate. Assumptions frequently interrelate and thus must be internally coherent. An assumption that seems reasonable alone may not be reasonable when combined with other assumptions (ASB 2003; PCAOB 2021b). Management, the valuation professionals, and the auditors should discuss the valuation's scope and how the valuation professional's work will be used well before the valuation begins. This can save significant time upfront and avoid possible delays in the audit (Murphy & Smith, 2017).

This paper builds on existing research (e.g., Martin et al., 2006) by reviewing the literature that has explicitly examined the audit of FVMs. Given the role that valuation specialists play, I include in this review an examination of the impact of using valuation specialists as part of auditing FVMs, as this issue has been explored in the existing literature. As part of this examination, in certain areas, I postulate relationships that can be further explored in future research.

In the remainder of this paper, I examine the existing literature, including propositions, and provide a conclusion.

LITERATURE REVIEW AND PROPOSITIONS

Auditor Responsibility for FVMs

When fair value estimates are made using valuation techniques, auditors should assess the risk that the estimate could be misstated by considering the uncertainty and subjectivity involved. Auditors use this risk assessment and their understanding of management's fair value estimation process to design their audit procedures. The auditor must consider whether management used reasonable and appropriate assumptions when estimating fair value and whether management could have used more appropriate assumptions if available information was unavailable (Menelaides et al., 2003). However, using multiple measurement attributes in financial statements creates difficulties for financial statement users. It is challenging to interpret aggregated financial statement line item amounts and individual financial statement line item amounts based on different measurement attributes (Barth, 2006).

In a synthesis of the extant literature on audits of fair value, Martin et al. (2006) suggest that auditors need more training to understand how FVMs are prepared and that the structures of audit teams may not be compatible with FVM audits. Auditors are likely to fall prey to biases when auditing FVMs. They should avoid confirmation bias when searching for evidence that corroborates management's assertions, but instead, search for evidence that could disconfirm management's assertions. Audit teams can look beyond their expertise for specialized valuation expertise.

Accounting Choice Theory

Evidence consistent with accounting choice theory suggests that due to contractual efficiency, information asymmetry, and managerial opportunism, managers will adopt fair value accounting when given a choice of adopting historical cost versus fair value (Quagli & Avallone, 2010). However, extensive psychology research suggests that individuals have little insight into how they combine information to form judgments (e.g., Dawes, 1971; Hammond & Summers, 1972; Kleinmuntz, 1990), which suggests that fair value valuation can be biased in favor of preferred directions (Bailey, 1986; Martin et al., 2006; Wilks, 2002). This requires management to use caution in describing how they utilize information to make judgments (i.e., estimating FVMs). When estimating FVMs, management may become overconfident because of the quantity of available information, making it impossible to consider alternative sources of information. As a result, managers may seek evidence supporting an earlier belief instead of evidence that disproves this belief when estimating fair value (see Martin et al., 2006). This leads to a proposition about the preparation of FVMs by management when management has to derive this measurement by evaluating multiple pieces of evidence.

Proposition 1: *When presented with voluminous information to support a FVM, the FVM prepared by management will be based on information presented earlier rather than information appearing later.*

Given that auditors are subject to the same psychological process of believing that earlier information is better than later information and that more information is better than less information, which is symptomatic of overconfidence (Davies et al., 1994; Paese & Sniezek, 1991; Slovic, 1982) I make the following propositions.

Proposition 2: *When presented with voluminous information to support a FVM, the auditor will utilize the information presented earlier rather than information appearing later.*

Proposition 3: *When evaluating information for relevance, the auditor will indicate that more information is superior to less information.*

Control Risk With the Audit of FVMs

Internal controls related to FVMs are likely more difficult to audit effectively than traditional transaction-based controls because FVM methods are revised frequently. Controls over FVMs are more difficult to audit because they rely on different mechanisms than controls over traditional accounting information based on historical costs (Barlev & Haddad, 2004; Martin et al., 2006). Financial reporting frameworks often call for neutrality, but accounting estimates are imprecise and can be influenced by management judgment. Management bias is inherent in subjective decisions often required in making an accounting estimate. Management bias can be challenging to detect at an account level. However, when the intention to mislead exists, management bias is fraudulent (ASB 2011).

Negotiation During the Audit of FVMs

Fair value accounting allows for negotiation when determining the fair value of an asset or liability. This may lead to negotiated accounting numbers in the final reports to be seen by the public (Wang, 2010). In emerging and transition economies, there are additional hurdles in preparing high-quality, verifiable fair value information, such as limited availability of practitioners with the necessary skills and experience,

limited access to market data, and the expense associated with developing fair value estimates. The reliability of FVMs becomes an issue as measurements move down the fair value hierarchy (FASB and IASB's Level 2 or 3). These measurements are prone to error because they are based on hypothetical market prices (Kumarasiri & Fisher, 2011). Auditing standards require auditors to evaluate whether an entity's financial statements contain any estimates with high estimation uncertainty and whether the uncertainty gives rise to significant risks. If so, the auditor must develop a range within which to evaluate the estimates (Christensen et al., 2012).

Thus, I propose the following:

Proposition 4: *Auditors will perceive a higher level of estimation uncertainty in emerging/developing countries than in developed countries.*

Proposition 5a: *When estimation uncertainty is high, there will be more negotiation in emerging/developing countries than in developed countries.*

The Increased Complexity in Financial Reporting

The length of footnote disclosures has continued to increase due to the release of numerous financial accounting standards and the increasing complexity of underlying transactions. The face of financial statements does not capture or display the uncertainty associated with some of the reported values, and the basic format and content of the financial statements have changed very little in recent decades (Christensen et al., 2012). While fair value standards require footnote disclosure, research suggests that these notes are not deemed as reliable as information stated on the face of the financial statements and that the information communicated in required disclosures inadequately communicates uncertainty (e.g., Davis-Friday et al., 1999; Ahmed et al., 2006; Libby et al., 2006; Mayorga & Sidhu, 2011; Espahbodi et al., 2002; Hodge et al., 2004; Griffin, 2011).

The inherent estimation uncertainty of fair values and other estimates is a critical feature that distinguishes auditing fair values and other estimates from other items. Strategic interactions between the audit firm and outsiders could distinctly influence audit quality. Measurement uncertainty arises, especially when an item has an illiquid or no market. This uncertainty is due to known statistical properties of model inputs and unknown factors that require judgment. Measurement uncertainty arising from input or model selection exists in a stable economic environment, but it is likely to persist in a volatile environment. (Bratten et al., 2013).

The Use of Valuation Specialists as an Integral Component of the Audit of FVMs

In addition to the relationship with regulators, audit firms have contractual and other market relationships with clients and other entities and utilize valuation specialists. These relationships and entity characteristics could affect the quality of an audit. The use of valuation specialists by both preparers and auditors is an issue. In particular, pricing services have been widely used in FVM, but regulators have expressed concern about preparers' and auditors' potential overreliance on specialists. The use of pricing services can enhance reporting and audit quality. Although statistical dependence may result from using pricing services for audit purposes, pricing services may improve reliability relative to other arrangements, such as internal modeling (Bratten et al., 2013; Deloitte, 2010; King, 2006a, 2006b).

Auditors are responsible for verifying the accuracy of financial reports, but accounting estimates are difficult to audit as they require subjective forecasts and judgment-based modeling. Auditors use multiple methods to evaluate assumptions and heavily depend on their judgment to determine how much evidence is necessary and what type of evidence is appropriate to evaluate management's assumptions (E. E. Griffith et al., 2015; Cannon & Bedard, 2016). The problems identified by interviewees and through analysis of PCAOB inspection reports reflect overreliance on management assertions, failure to test assumptions and data, and failure to consider controls over management's process and the data. This views the problems with complex estimates as arising from the legitimation propositions of institutional theory (E. E. Griffith et al., 2015).

The institutional theory posits that organizations achieve legitimacy by adapting practices that have already been accepted as legitimate within their environment. It is difficult for people on the margins to change these practices. Organizations' legitimacy-oriented development of practices can have two significant consequences: the practices may not be appropriate for the specific organization or task. Novel practices risk being viewed less favorably because they diverge from already standardized (and thus accepted) practices. As a result, organizations tend to adopt increasingly similar practices in their pursuit of legitimacy (e.g., Meyer & Rowan, 1977; Pfeffer, 1981; DiMaggio & Powell, 1983; Zucker, 1987; Greenwood et al., 2002; Garud et al., 2007).

In an experimental study examining the combined effect of estimate source and social pressure using Chinese auditors as respondents, evidence suggests that their judgments of fair value estimates are influenced by the type of social pressure they are under and the source of the estimate (Brink et al., 2016).

Auditors' inherent risk assessments are affected by the uncertainty of the valuation model and assess greater inherent risk under extreme than moderate uncertainty (Cannon & Bedard, 2016). The use of specialists is a frequently employed audit risk mitigation strategy. The level of risk is a crucial reason for engaging a valuation specialist, but specialists are often used for high-risk accounts. Auditors will likely use a valuation specialist to assist the engagement team as inherent and control risk assessments for the FVM increase. This is because the parties' position in auditor/client negotiations improves with greater expertise (Gibbins et al., 2001; E. Griffith, 2015; McCracken et al., 2008).

Auditors' use of pricing services and valuation specialists varies for financial and nonfinancial financial valuations. Key factors driving decisions to use pricing services or valuation specialists include firm resources, nature of the security, and firm policies. Evidence suggests that nonfinancial FVMs present more challenges than financial FVMs. That lack of observable market information and management's lack of valuation knowledge are the key factors increasing the audit difficulty. Pricing services provide estimates that are not customized for a particular audit firm or company. Audit teams rely on in-house specialists to assist with evaluating the most subjective aspects of management's estimates. When the difference between management's estimate and a pricing service's estimate is within the auditor's tolerable range the auditor typically performs additional audit procedures to test management's assumptions, the valuation model, and the underlying data (Glover et al., 2016).

In a review of the extant literature on auditor use of specialists, Hux (2017) suggests there are common factors associated with auditors' use of specialists: (1) the need for skills and expertise, (2) complexity, (3) risk, (4) budget, and (5) firm guidance/decision aids. Given the vast array of clients they serve, specialists can provide a level of expertise that is otherwise not available to the auditor. There are many different types of specialists in auditing, and auditors must consider who among the available specialists has the relevant expertise for the audit. Also, firm size impacts the availability of subject-matter expertise and the extent of specialist use. The need for a specialist is influenced by engagement complexity. For example, when an accounting measure has a high degree of estimation uncertainty, a high degree of judgment embedded in the valuation assumptions, and the utilization of proprietary valuation models, the use of valuation specialists is usually warranted.

When management provides the auditor with highly quantitative data and the risk of the control environment is high, auditors make trade-offs when choosing procedures to test the client's FVMs (Joe et al., 2017). Financial accounting estimates are based on subjectivity, complexity, and uncertainty and should be revisited and revised as necessary in future reporting periods based on new information. Auditors should understand and document underlying assumptions and management's rationale in arriving at fair values. Management or a third-party valuation professional will develop a valuation model for valuing certain financial statement items using unobservable assumptions. Auditors need to be alert that management must calibrate those assumptions on subsequent measurement dates. (Levy, 2017; Murphy & Smith, 2017).

Auditors are often ill-equipped to assess the reasonableness of some elements in estimates, so they rely on valuation specialists' help. Auditors who recognize patterns among assumptions are more apt to identify misstatements in estimates. Valuation specialists have domain-specific expertise that auditors often lack, and their work can help them spot potential problems early on. Auditors use industry specialists' work more effectively when situational factors indicate higher risk and disregard their work when factors indicate

lower risk. Industry specialists have richer problem representations that aid pattern recognition. Auditors' problem representations and pattern recognition could benefit from incorporating consultants' cues. Auditors struggle to identify misstatements indicated by problematic patterns among assumptions underlying estimates when those assumptions appear reasonable individually. When auditors receive a relational cue and a situational factor indicating a higher risk of misstatement, their problem representations improve and are more likely to suggest adjusting an estimate (E. E. Griffith, 2018). However, the ability of the auditor to rely on the work of the specialist might be affected by the work environment. When specialists perceive a lack of respect from auditors, they distrust auditors and are less willing to perform procedures that they perceive can reduce audit risk (Barr-Pulliam et al., 2020).

Thus, I derived the following proposition and research question:

Proposition 6: *When specialists detect a negative relational cue from auditors, the specialists will perform fewer tasks.*

Research Question 1: *When specialists detect a negative relational cue from auditors, will the specialists' accuracy decrease?*

CONCLUSION

The increasing use of valuation specialists, the increased assessment of control risk for FVM, and the possible consequences of negotiation are areas of concern for the auditing profession. In this paper, I have identified and formulated propositions and a research question that will increase our understanding in each of these critical areas. The propositions and research question identified in this paper have not been empirically tested. I suggest future studies empirically test those propositions and research questions identified in this paper, which would contribute significantly to the literature in this area.

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