

Deficiencies in the Audit of Fair Value Measurements

A Case Study in an Accounting Firm



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Abstract

The increasing presence of fair value measurements (FVMs) in accounting and financial reporting has had implications for the role of the auditor. According to previous literature, there are numerous direct and indirect factors that complicate the audit of FVMs. Bratten et al. (2013) classify these so-called 'audit deficiencies' that appear in literature into a framework, distinguishing environmental, task-specific and auditor-specific deficiencies. Despite insights of multiple academic studies and regulators' attempts to improve audit performance, deficiencies continue to persist. A better understanding of the audit process of FVMs and the related deficiencies is needed and insights from the perspective of the auditor contribute to this purpose. By drawing upon the framework of Bratten et al. (2013), this research investigates how auditors perceive deficiencies in the audit of fair value measurements. A case study at a 'Big Four' accounting firm is performed, involving the examination of written audit procedures and interviews with auditors that are experienced in auditing FVMs. Results show that auditors perceive the audit of FVMs as complex, mainly due to the subjectivity and uncertainty inherent to management's assumptions and the fair value model. Moreover, the auditor's knowledge and expertise may not be sufficient to audit FVMs, making him dependent on the assistance of an internal valuation specialist.

Preface

This thesis is the completion of my Master's programme in Economics in the specialization Accounting & Control. It concludes six years of studying at the Radboud University in Nijmegen, a period to which I look back with great fondness. The knowledge and competences I gained at university will be valuable in my professional career. I have also had the chance to develop myself in extracurricular activities. Highlights in this matter were being a member of a sports club and a fraternity, being the treasurer of my sports club for one year, and studying a semester abroad in Warsaw. I am very grateful for all the opportunities I have had during my time in college.

Even though I am satisfied with the final result of my Master's thesis, the process of writing it during the last couple of months have been tough now and then. I would like to express my gratitude to a few people who supported me during this process. First of all, I would like to thank my supervisor Reinald Minnaar. I appreciate his help during my topic selection and his critical and valuable feedback in the following stages of my research. I also would like to thank Max Visser for being the co-reader of this thesis. Moreover, I would like to thank KPMG for giving me the opportunity to write my thesis during my internship at the firm. In particular, I am grateful to the auditors of KPMG who provided the input for this research during the interviews. I enjoyed the conversations and I learned a lot about the audit process and fair value accounting in particular.

Finally, as this thesis is the completion of my Master's degree, my time as a student has come to an end. Therefore, I would like to thank my parents for everything they did for me over the last six years. Their support and love mean a great deal to me. Also thanks to my girlfriend, for her understanding and support whenever I needed it. Thanks to my brother, for his useful advises as an older brother. Last but not least, thanks to all my friends who have made my time as a student in Nijmegen unforgettable.

I hope you will enjoy reading this thesis.

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1. Introduction

1.1 Audit of Fair value measurements

In recent years, within the field of accounting, emphasis has shifted from accounting based on 'historical cost' to accounting based on 'economic reality' (Glover, Taylor & Wu, 2015). Accounting numbers based on historical cost provide a reliable and verifiable record of the transactions of an enterprise in the past. In contrast, accounting numbers based on economic reality are reflecting current market prices informing current economic decision-making. Representing numbers in such a way is also referred to as fair value accounting (Barker & Schulte, 2016). The use of fair value measurements (FVMs) reflecting current economic values is more relevant for users of financial statements. Even though they have some measurement uncertainty, investors prefer FVMs to historical cost measures, which are easy to verify but also irrelevant to decision-making (Christensen, Glover & Wood, 2012).

The shift to a fair value environment has had implications for the role of the auditor. Originally, the auditor was testing tangible evidence according to objective procedures. However, as FVMs are becoming predominant, there is now increasing reliance on the auditor's professional judgment. This is due to the subjectivity in estimating future events, the use of complex financial instruments and economic volatility, which are all factors inherent to measuring fair value. These factors cause a potential high degree of measurement uncertainty and therefore make the audit of FVMs a challenging task (Singh & Doliya, 2015; Glover, Taylor & Wu, 2016). To reduce measurement uncertainty, auditors apply audit procedures and rely on internal and external valuation specialists, consistent to audit standards. However, the Public Company Accounting Oversight Board (PCAOB) has expressed concerns about the audit of FVMs in several inspection reports, stating that there are repeating deficiencies related to FVMs (PCAOB 2012, 2015).

In existing literature a growing number of authors also identify these audit deficiencies and remark that the task of auditing uncertain valuations is difficult, complex and unstructured (Cannon & Bedard 2016). Deficiencies on the audit of FVMs relate to a wide variety of characteristics of the audit profession, for instance, the aforementioned estimation uncertainty and the complexity of the auditable FVM. Another issue is the tendency of auditors to rely too much on (subjective) assumptions of management during the inspection of fair values. This gives opportunities for managerial bias, which can affect the final result of FVMs (Griffith, Hammersley & Kadous, 2015). Bratten, Gaynor, McDaniel, Montague and Sierra (2013) point out that some deficiencies arise from the audit staff lacking sufficient knowledge and

understanding of the assumptions underlying fair value calculations. This undermines the auditor's ability to identify, evaluate and communicate concerns about the valuations to management or valuation specialists. The engagement of internal or external valuation specialists to assist in complex valuations during the audit of FVM is considered valuable. However, according to Glover et al. (2015) it gives rise to some audit issues as well. They find evidence of occasional overreliance of auditors on valuation specialists.

1.2 Research question

The introduction of fair value-based measurements in the accounting standards has caused numerous auditing issues to arise in the fair value environment. The identified deficiencies related to FVMs can decrease the quality of the audit and consequently the reliability of the financial statements (Glover et al. 2016). Still, auditors are tasked with providing assurance on FVMs and their responsibilities regarding managerial assumptions and accounting estimates are likely to increase. Hence, it is important to evaluate the sources of audit deficiencies and figure out ways to improve the audit of FVMs (Bratten et al. 2013).

This study investigates the audit process of FVMs at KPMG Arnhem. The purpose of this study is to gain insights into the characteristics of this audit process, the auditors' perception of this process and the potential deficiencies that are perceived. These insights provide an answer to the following research question: *How do auditors perceive deficiencies in the audit of fair value measurements?* The sub questions that are formulated to assist in finding an answer to the research question are:

- 1: What is fair value?
- 2: Which are deficiencies related to the audit of fair value measurements?
- 3: How can the audit process of fair value measurements at KPMG Arnhem be characterized?
- 4: How do auditors of KPMG Arnhem perceive the audit of fair value measurements?
- 5: How do auditors of KPMG Arnhem deal with potential audit deficiencies?

Bratten et al. (2013) summarize the audit deficiencies that appear in existing literature. In doing so, they rely on a theoretical framework of Bonner (2008) that investigates auditor judgment by analysing three critical and interactive factors of the judgment and decision-making process. These three factors relate to the environment, the task and the person. Accordingly, Bratten et al. divide the audit deficiencies in the following way:

- Environmental factors, which relate to the surroundings of the auditor. Examples of environmental factors are relations with outside entities, estimation uncertainty and regulatory influence.
- Task-specific factors, which relate to factors as task difficulty, task structure and management bias.
- Auditor-specific factors, such as valuation knowledge and expertise, professional scepticism and cognitive limitations.

This way of classifying audit deficiencies will be leading throughout this thesis.

In order to acquire data to answer the research question, an interpretive case study at KPMG Arnhem will be performed. The case study includes interviews with auditors having sufficient experience with the audit of FVMs and who are familiar with multiple aspects of this audit process.

1.3 Relevance

In recent years, a lot of studies investigated the audit of fair value measurements. Some studies provided a comprehensive overview of factors that make the audit of FVMs a challenging job (Bratten et al., 2013; Doliya & Singh, 2016). Other studies have focused on one of these factors individually (e.g. estimation uncertainty or the engagement of valuation specialists) and provided evidence for deficient audit performance (Christensen et al., 2012; Griffith, 2016). In addition, international regulatory institutions like the PCAOB and the International Forum of Independent Audit Regulators repeatedly express concerns on deficiencies related to FVMs in their inspection reports. Despite these insights provided by multiple academic studies and regulators' attempts to improve audit performance, deficiencies keep on recurring (Glover et al., 2015). A better understanding of current audit practices is therefore needed, according to the PCAOB reports (2014; 2015), and more insights from experienced auditors assist in this matter. Also Barker and Schulte (2016) call for an investigation of fair value representations from the perspective of the auditor. This study can therefore contribute to these issues.

From a societal point of view, this study can provide insights for audit firms that are to dealing with fair value measurements on a regular basis. For KPMG Arnhem in particular, this research is useful to gain a better insight in how its auditors perceive the fair value audit process, and where potential deficiencies in the audit process arise.

1.4 Structure

The following chapters of this thesis are organized as follows. Chapter 2 provides a literature review, in which the fair value concept is explained and deficiencies related to the audit of FVMs are discussed. In chapter 3, the research method is illustrated. The results of this research are presented in chapter 4 and these results are analysed in chapter 5. The final chapter contains the conclusion and the discussion.

2. Literature

This literature review is divided into two parts. In the first part the concept of fair value is defined, explained and elaborated in order to answer the first sub question: What is fair value? In the second part the deficiencies related to the audit of fair value measurements are discussed according to the classification of Bratten et al. (2013). This part concerns the second sub question: Which are deficiencies related to the audit of fair value measurements?

2.1 Fair Value

2.1.1 The introduction of IFRS 13

Since January 2005, all companies listed on stock exchanges in Europe are obliged to report their financial statements in accordance with International Financial Reporting Standards (IFRS) (Devalle, Magarini & Onali, 2014). Together with the mandatory adherence to IFRS, the presence of the fair value concept in accounting has increased over the recent decades. The International Accounting Standards Board (IASB), the organization responsible for setting IFRS, prefers the fair value approach in financial reporting because it provides more relevant information to investors, potential investors and other users of financial statements, who need this information in economic decision-making. (Jermakowicz & Gornik, 2006; Gjerde, Knivsflå & Sættem, 2008).

The fair value concept is present in numerous IFRSs, allowing or requiring firms to measure assets and liabilities at fair value. However, there were some shortcomings in the guidelines of fair value: specifications on how to measure and disclose fair value were spread over many different IFRSs, they lacked a clear measurement objective and they were sometimes contradictory. To improve this limited guidance, the IASB started a project in 2010 in cooperation with the Financial Accounting Standards Board (FASB), the national standard setter in the US. Their common purpose was not only to unify the use of fair value throughout the different IFRSs, but also to converge the fair value guidelines of IFRS and US General Accepted Accounting principles (US GAAP) into one uniform set of requirements. As a result of this joint project, the IASB issued IFRS 13 in 2011. The FASB, in turn, updated SFAS 157, its own standard on fair value measurement. In this way, both IFRS and US GAAP now use the same definition of fair value and provide consistent approaches on *how* to measure fair value. Note that still some discrepancies exist between the two standards, such as *when* to use fair

value measurements and to *which* assets and liabilities this approach should be applied (Dvořáková, 2013; Ernst & Young 2012; IFRS, 2013). To explain the concept of fair value in the following paragraph, there is opted to rely solely on IFRS 13, as SFAS 157 and IFRS 13 are in general similar in defining fair value.

2.1.2 Fair value defined

Fair value is defined by IFRS 13 (2011) as follows:

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

Considering this definition it is evident that fair value measurements are market-based and not entity-specific. The management of an entity uses the assumptions that market participants would use when determining the value of an asset or liability under actual market conditions. When measuring fair value, it is therefore irrelevant what the management’s intention is for holding the asset or settle the liability (IFRS, 2011).

Fair value is the price to sell an asset or liability. The price represents an exit price notion, in which firms exit the positions they are holding. IFRS (2011) states that this exit price is taken “either from the principal market or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the market with the greatest volume or level of activity for the particular asset or liability.” Generally it is assumed that this is the market that a firm would usually enter for a transaction. A firm first analyses the possible markets it can enter and then decides which market is most favourable in terms of volume and liquidity for the particular asset or liability. The firm is not expected to put extensive effort in figuring out which market would be the principal market or, in absence of a principal market, the most advantageous market. However, it is expected to consider all relevant evidence that is reasonably available. After the principal market has been identified, the fair value measurement reflects the price in that market, even if in another market the price might be more advantageous at the measurement date (IFRS, 2011).

Sometimes the identification of a principal (or most advantageous) market can be affected due to a lack of observable markets. For some assets and liabilities there may be no observable market transactions or no market information available. In that case the entity uses another valuation technique to measure fair value. While applying another valuation technique,

the use of relevant observable inputs should be maximized and the use of unobservable inputs minimized. These inputs must be consistent to how a market participant would price an asset or liability (IFRS, 2011).

To contribute to the understanding of the fair value concept, the different elements of the fair value definition are explained separately. According to Ryan (2008), an orderly transaction refers to an unforced, deliberate transaction in which the company is expected to perform usual commercial activities in order to find potential buyers of assets and parties that are willing to take over liabilities. The other party involved in the transaction is expected to perform usual due diligence. Also Dvorakova (2013) emphasizes the unforced nature of this transaction, stating that fair value is “the price concluded between free parties without any compulsion between subjects on the market.” The rationale of both parties to engage in this transaction is the profit. The transaction in the definition is obviously hypothetical (IFRS, 2011).

Market participants are, according to Ryan (2008), actors in the market that are well-informed, unrelated to each other, and willing and able to do business. These actors possess sufficient knowledge about the market conditions due to the due diligence they carried out before the transaction. They determined as best as possible the fair values of the asset or liabilities at stake. Dvorakova (2013) describes the transaction between the actors as an at arm’s length transaction. The actors are independent from each other and act in their own interest (IFRS, 2011).

With the measurement date is meant that the fair value should reflect the market conditions on the balance sheet date. So, if there is on this date a very high credit risk premium in comparison to the premium that would be normally expected, then this unusual high premium should be incorporated into the fair value. Expectations of the premium turning to a normal value again in the future should not be incorporated in the fair value. Not even if statistics, historical numbers or experts suggest it (IFRS, 2011; Ryan, 2008).

2.1.3 Fair value hierarchy

The inputs that are used in valuation techniques for determining fair value are categorized in IFRS 13 into three hierarchical levels. In the highest level there are the so-called level 1 inputs, which are the most observable and most reliable inputs. These inputs are quoted prices in active markets where assets and liabilities are identical to the asset or liability that is to be measured. A condition is that the firm should be able to access these identical assets or liabilities at the

date of measurement. As these quoted prices are the most reliable indication for measuring fair value, they should be used whenever they are available and without making any adjustments to them (with few exceptions). This is also referred to as ‘marked to market’. For some financial assets and liabilities there may be more than just one active market available. In level 1 it is therefore important to assess which is the principal (or most advantageous) market, and whether it would be possible for the firm to transact in that market at the particular measurement date (IFRS, 2011; Hermanson et al., 2017; Laux & Leuz, 2010).

The inputs categorized in level 2 can be quoted prices for identical assets or liabilities, but not from an active market. They can also be quoted prices for similar assets or liabilities in active markets. Or they may be observable inputs other than quoted prices, such as interest rates or credit spreads. And lastly, the inputs could be market-corroborated inputs. These are not directly observable inputs, but they are confirmed by observable market data derived from statistical analysis. Level 2 inputs must be observable for the full term of the contract of an asset or liability (IFRS, 2011).

Level 3 inputs are unobservable and less reliable. They are used when there are no relevant observable inputs available for measuring fair value. IFRS allows in this way for situations with little or no market activity for the asset or liability to be measured. As the objective of fair value measurements is to reflect an exit price from the perspective of a market participant on the measurement date, the unobservable inputs represent market participant’s assumptions when assessing the value of an asset or liability. These assumptions include the inherent risk in a valuation method and the inherent risk in the inputs to that method. Thus, if a market participant includes a risk adjustment in the valuation of the asset or liability, for instance when there is substantial measurement uncertainty, then an entity should include that risk adjustment too. Otherwise the measurement would not be a fair value measurement. In developing unobservable inputs, an entity should use all relevant information that is reasonably available. However, the entity is not required to put extensive effort in finding the best information. The best information available might come from the entity’s own data. (IFRS, 2011; Hermanson et al., 2017).

2.1.4 Relevance of fair value

The IFRS (2011) formulates the objective of financial statements in International Accounting Standard 1 (IAS 1) as “to provide information about the financial position, performance and changes in the financial position of an entity that is useful to a wide range of users in making

economic decisions.” Fair value accounting information matches with this goal, as the main advantage of an increasing application of the fair value concept is the higher relevance of accounting information. This higher relevance, together with an increased comparability and neutrality of the accounting information, increases decision usefulness. In addition, there are multiple other arguments mentioned in literature in favour of the use of fair value. Fair value measurements provide a better basis for analyses and predictions about the future because expectations about the future, such as risks and revenues, are taken into account during the application of fair value accounting. Furthermore, fair value measurements reflect changes in financial conditions that arise from fluctuating interest rates and provide warning signals for financial problems. This is due to the fact that economic events are taken into consideration in the period that they actually take place. The measurements are updated on the financial statements in accordance with a change in the value of an asset or liability. Therefore fair values provide timely information, increase transparency and stimulate fast adjustments (Hirst et al., 2004; Ronen, 2008; Whittington, 2008; Laux & Leuz 2010; Dvorakova, 2013)

2.1.4 Reliability of fair value

On the other hand, various disadvantages of and arguments against fair value appear in existing literature. While a larger relevance is often named as the most important benefit of fair value, lower reliability and verifiability are generally among the downsides of fair value that are mentioned first. Level 1 measurements are taken from observable markets prices and are therefore reliable. Level 2 and level 3 measurements, however, are less reliable as they may contain measurement errors. Especially level 3 measurements may cause reliability concerns, as they consist of unobservable inputs that are subjectively determined by an entity’s management. Thus, in fair value accounting management has considerable discretion and there is room for manipulation, in comparison to the alternative historical-cost accounting, where assets and liabilities are recorded at the value of the original purchase. Other disadvantages are more fluctuations in the reporting of gains and greater emphasis on the short-term. Financial institutions will be more focused on the short-term because shares are in the short-term less subject to fluctuations. (Hodder e.a., 2006; Ronen, 2008; Ryan, 2008; Laux & Leuz 2010; Dvorakova, 2013, Hermanson et al., 2017)

2.2 The audit of fair value measurements

Auditors are tasked with the control of the financial statements of their clients. The responsibility of auditors is to identify material misstatements in the financial statements in order to provide reasonable assurance that there are no errors of material importance. However, there is always some uncertainty in this process that may cause some errors to remain unidentified. If the auditor approves the financial statements and consequently issues an unqualified audit opinion while some material misstatements have not been identified, the errors may go public. The negative consequences for the auditor can be severe. The client can end the engagement, the auditor might face litigation, revenue streams can get affected and the reputation of the auditor might worsen. Also the users of financial statements that rely on accounting information will be affected (Simunic & Stein, 1996; Houston, Peters & Pratt, 1999; AICPA, 2011; Christensen et al., 2012).

The use of fair value in financial reporting is increasing as standard setters such as the IASB call for wider acceptance and application of fair value. This will have some implications for the role of the auditor. It is expected that a higher proportion of the auditor's activities will be focused on the audit of fair value measurements. The audit effort will be more challenging because the audit of fair value will become more important and complex (Martin, Rich and Wilks, 2006; Bratten et al., 2013).

2.2.1 Deficiencies related to the audit of fair value measurements

The PCAOB, a corporation that supervises the audit of public firms, has expressed in its inspection reports a number of deficiencies related to the audit of FVMs (PCAOB, 2012). The International Auditing and Assurance Standards Board (IAASB), an entity that sets standards to support audits of financial statements, states that auditor-specific characteristics such as a lack of valuation knowledge, contribute to audit deficiencies related to FVMs (IAASB, 2008a). Besides these concerns expressed by regulatory agencies, a number of research papers in accounting literature suggest that audit deficiencies relate to factors involving the audit environment and the audit task. In their paper, Bratten et al. (2013) summarize the audit deficiencies that appear in accounting literature, reports of regulators and reviews of standard setters. The deficiencies are categorized into three groups: environmental factors, task factors and auditor-specific factors. An overview of this classification is provided in Table 1.

Environmental factors	Task factors	Auditor-Specific factors
Estimation uncertainty	Task difficulty	Valuation knowledge and expertise
Regulatory and legal influences	Task structure	Professional scepticism
Audit firm relationships with outside entities	Management bias	Cognitive limitations and processing demands

Table 1: Environmental, Task and Auditor-Specific factors (Bratten et al., 2013)

The classification is based on a framework of Bonner (2008). He states that the factors in the scheme both independently and interactively affect the quality of judgments auditors make. For example, an interaction between the environmental factor estimation uncertainty and the task factor task difficulty may cause auditors to lack professional scepticism (an auditor-specific factor). So even though the factors are listed in the scheme as independent factors, the interaction with other factors must be taken into account.

2.2.2 Environmental factors

Environmental factors relate to the surroundings of the auditor. They are not specifically related to the auditor himself, nor to the task he performs. Environmental factors, for instance macro-economic risks, can influence any audit, yet they are critical to the audit of FVMs.

2.2.2.1 Estimation uncertainty

An environmental factor that is essential to the audit of FVMs in comparison to the audit of other items is estimation uncertainty. The International Standards on Auditing (ISA) 540 defines estimation uncertainty as “the susceptibility of an accounting estimate and its related disclosures to an inherent lack of measurement precision” (IAASB, 2008a). Less precise fair value measurements increase the risk of material misstatement (Bratten et al., 2013). Estimation uncertainty consists of two components: measurement uncertainty and macro-economic risks.

Measurement uncertainty

Measurement uncertainty refers to the absence of a general agreed-upon method for the valuation or estimation of an item on the financial statement. Even fair value experts can

disagree on which valuation or estimation method should be applied for an item, particularly in situations with little or no market activity for the asset or liability to be measured. Preparers of financial statements should therefore follow the fair value hierarchy. This means they should use observable level 1 inputs for their valuation model, rather than the less observable level 2 inputs or the unobservable level 3 inputs. The subjectivity inherent to level 2 and level 3 inputs, as well as the statistical properties of model inputs, give rise to measurement uncertainty (Bratten et al., 2013).

One of the findings of the research of Cannon and Bedard (2016) is that estimation uncertainty inherent in complex fair value measurements equals or exceeds the tolerable materiality level in more than 70 percent of their observations. They identify a lack of sufficient and reliable information as a key factor for high uncertainty. In addition, they find that auditors encounter difficulties in choosing which valuation method to apply. There are multiple models available, but distinguishing them is challenging due to assumptions that are difficult to verify and subjective model inputs. Folpmers and De Rijke (2010) value a mortgage-backed security with observable level 2 inputs, unobservable level 3 inputs and simulation. They find that the estimate's value is so dispersed that the true risk will not be reflected in the expected value of the security. The security will probably be valued too high, but adjusting the expected value would involve subjectivity.

Christensen et al. (2012) show that minor changes to fair value inputs – changes of an acceptable uncertainty level, selected subjectively by management – can cause substantial changes to account values or even to net income. These effects can be fifty times larger than the materiality level considered acceptable by the auditors of big accounting firms. Audit standards require auditors to provide a high level of positive assurance that accounts in the financial statements are fairly stated within the materiality range. However, business transactions, reporting standards and estimates became more complex and uncertain over the recent decades. Meanwhile, the nature of audit assurance to be provided on uncertain estimates, the information conveyed by these estimates and the format of the audit report changed very slightly. This results in a more difficult task for the auditor and likely places an unrealistic burden on them. The authors question whether the auditors are still able to ascertain that the estimate is fairly presented. This does not mean that the auditor is incompetent, nor that the fair value concept is being condemned. Rather, it means that no matter the magnitude of the audit, there will always be significant inherent uncertainty in reported amounts that are determined by management's valuation models – models that are based on level 3 inputs and that are extremely sensitive to small changes in these inputs.

Macroeconomic risks

As explained above, measurement uncertainty is induced by the selection of inputs and valuation models by managers and therefore makes the audit of fair value measurement a challenging task for auditors. Measurement uncertainty occurs in stable economic circumstances, but can be heightened in times of economic distress (IAASB, 2008b). In addition, there are multiple other macroeconomic risks that can affect the reliability of fair value measurements. The PCAOB (2011) mentions market volatility as a factor that can increase the risk that a valuation model is used improperly or contains errors. Christopher Whalen, a risk specialist, stated that during the credit crisis of 2008 it was hard for bankers and auditors to observe actual prices due to the distress in the market, making prices less reliable to represent fair value (Hughes & Tett 2008). Systematic macroeconomic risk factors, such as inflation or changes in interest rates, are unpredictable and not always possible to avoid, and may therefore raise concerns about the validity of the model and its inputs. Audit and accounting regulators share these concerns and warn for less reliable fair value measurements and a more challenging fair value audit as a result of macroeconomic events (IAASB, 2008b; PCAOB, 2011).

2.2.2.2 Regulatory and legal influences

The regulatory and legal systems of a country can affect the quality of the audit. There is a dual structure in the systems, consisting of rule making bodies and supervising bodies. Regulators such as the IASB issue standards – IFRS – that define which behaviour is appropriate, and supervising institutions, such as the European Securities and Markets Authority (ESMA), are tasked with the enforcement of those standards. Moreover, in cases of criminal actions, offenders are sanctioned and penalized through lawsuits by the respective court to which the offender is subject to (Bratten et al., 2013).

Although there is not much evidence on the effect of regulatory pressure on auditors that audit fair value, there is evidence that regulatory pressure tempers aggressive financial reporting. For instance, Vyas (2011) finds that write-downs of assets occur on a timelier basis if there is a threat of investigation by a supervising body or a pressure of facing litigation. Van de Poel, Maijor and Vanstraelen (2009) show that the higher the quality of a legal system, the more frequent and more conservative goodwill impairments are recognized under IFRS.

The fact that these findings show that regulatory pressure positively affects preparers of financial statements, suggests that this pressure could also create some incentives for auditors

to increase the quality of the audit of fair value measurements. In fact, during the recent financial crisis auditors' compliance improved as there was stricter supervision and fear of being exposed to 'Enron-sized' lawsuits (Hughes & Tett 2008). However, in their qualitative research among auditors with experience in fair value audits, Glover et al. (2015) find different opinions between audit experts and inspection experts regarding the inspection of complex FVMs. These differences stem from judgment bias and a lack of inspector knowledge and expertise, different expectations on what can be an acceptable level of accuracy in the valuation of FVMs, and lack of guidance on what comprises sufficient audit evidence.

2.2.2.3 Audit firm relationships with outside entities

Besides the relationships with regulators, audit firms have contractual relationships with other entities. Examples are contractual relationships with the client firm or auditee, competitive relationships with other audit firms, and the engagement with valuation specialists. These relationships are mutually agreed-upon, in contrast to the compulsory relationships with regulators. In the next section, the focus is on the relationships of the audit firm with (1) the auditee and (2) the valuation specialists, as these relationships can have an obvious effect on the audit of FVMs (Bratten et al., 2013).

Relationship with the auditee

Two important aspects of the relationship between the audit firm and its client are first-mover advantage and auditee-pay model. First-mover advantage refers to the management that is reporting values prior to the audit, during which the auditor checks whether the reported value is reasonable. In particular, management can take advantage of being the first-mover while reporting fair values because of the inherent measurement uncertainty to fair values. The first-mover advantage therefore negatively affects auditor's judgment quality (McDaniel & Kinney 1995; Earley, Hoffman & Joe, 2008). The auditee-pay model refers to the client firm paying for the audit, suggesting the auditor could have incentives for providing a favourable opinion. This raises concerns in literature, as the auditee-pay model is recognized as a source of conflict between the audit firm and the client firm (Bratten et al., 2013). However, research specific to the audit quality of FVMs is limited. Goncharov, Riedl and Sellhorn (2012) and Ettredge, Xu and Yi (2014) showed that audit fees increase when the complexity of fair values increases, but these findings cannot be directly related to audit quality.

Positive relationships also appear when factors such as corporate governance and audit firm size are being investigated in relation to audit quality in general. However, researches specifically related to audit quality of FVMs yield distinct outcomes. On the one hand, Song, Thomas and Yi (2010) find that firms with strong corporate governance have more reliable level 3 fair value estimates. De Zoort, Houston and Hermanson (2003) on the other hand, find that the auditor receives less support from the audit committee when there is a disagreement regarding estimates. Finally, with respect to audit firm size, Dietrich, Harris and Muller (2001) find that investment properties estimated at fair value are more reliable when audited by 'Big Six' accounting firms in comparison to non-'Big Six' firms.¹

Relationship with external valuation specialists

As FVMs are complex and involve considerable estimation uncertainty, both auditors and preparers regularly engage external valuation specialists that are highly skilled and possess specific knowledge and expertise to assist in measuring items at fair value. The output generated by the specialists can significantly affect, positively and negatively, the quality of financial reporting and the quality of the audit (Bratten et al., 2013; Doliya & Singh, 2016).

A survey of Deloitte (2010) finds positive effects of the use of pricing services on the quality of audit and financial reporting. 73 percent of the asset managers in the survey believe that engaging pricing services generates more reliable numbers than engaging brokerage services. In addition, 60 percent of the firms in the survey have separate committees for fair value and all of them use pricing services. Lastly, 97 percent of the asset managers said they challenged the valuation of the pricing service, suggesting that companies do not rely too much on external specialists. In contrast, there are some studies that report occasional overreliance on third-party specialists (Glover et al., 2015; Pyzoha, Taylor & Wu, 2016). Griffith (2016) demonstrates another factor that negatively affects the quality of the audit of FVMs, by conducting interviews with auditors and specialists. She suggests that auditors' reliance on fair value specialists ultimately causes auditors to feel that their jurisdictional claim to the audit is threatened. Auditors try to defend their claim by asserting that they have enough knowledge to fulfil the task themselves and by keeping that knowledge from others. This behaviour includes filtering information, altering the work of the specialist and deleting information they consider

¹ In 1989 the 'Big Eight' accounting firms Ernst & Whinney and Arthur Young merged into Ernst & Young and the firms Deloitte, Haskins & Sells and Touche Ross merged into Deloitte & Touche. From that moment on until 1998, the largest accounting firms were referred to as 'the Big Six', the other four being Arthur Andersen, Coopers & Lybrand, KPMG Peat Marwick and Price Waterhouse (Wootton & Wolk, 1992).

unimportant. This defensive behaviour creates altogether a tendency to make the specialist work in accordance with the perspective of the audit team. In this way the auditors undermine the original purpose of engaging the specialist, which was to attract expertise and viewpoints the auditors lack. This behaviour of auditors is confirmed by the answers of the specialists and, ironically, the specialists believe that they just have a supporting role to the audit of fair value and they do not seem to pursue any jurisdictional claim.

2.2.3 Task factors

The task in auditing fair value measurements refers to the responsibilities of the auditor and is related to the complexity of the reporting standards that FVMs and disclosures are subject to (Bratten et al., 2013). Bonner (2008) describes task factors as factors that have an effect on the task's nature and on the performance of the individual. The main task factor that affects FVMs is task complexity, as environmental factors such as estimation uncertainty complicate the task for auditors and negatively influence their performance. Task complexity is divided in task difficulty and task structure. The interaction between the task factors and environmental factors may give rise to opportunities and incentives for management bias, which is the final task factor that is discussed (Bratten et al., 2013).

2.2.3.1 Task difficulty

Dynamic economic circumstances and the estimation uncertainty inherent to fair value complicate the audit of FVMs. Besides, auditors are challenged by the decisions of management in the valuation of a FVM. Management may use multiple different methods and inputs and to audit these models and assumptions an auditor needs skills he might not possess. The knowledge and expertise required are more related to finance and economics than to accounting. If auditors obtain more expertise in auditing fair value, the task difficulty is likely to decline. However, the afore-mentioned complexities inherent to fair value cause even experts to experience greater processing requirements during the audit of FVMs in comparison to, for instance, the audit of accounts receivable (Bratten et al., 2013). By conducting interviews with auditors, Griffith, Hammersley and Kadous (2012) find that auditors acknowledge task difficulty. The auditors confirm that they sometimes do not understand management's assumptions underlying the estimate. They also fail to sufficiently test these assumptions and other data and they do not recognize which assumptions are most important. Even if auditors understand the models and methods used by management, it can still be difficult to assess

whether the selected assumptions are appropriate. DeZoort et al. (2003) state that even if auditors possess the expertise necessary to make independent valuations themselves, their assumptions may differ from the (subjective) assumptions used by management's specialists. As a result, the auditor must justify his own subjective adjustment. However, in these situations regarding subjective valuations audit committees usually support management, which makes an adjustment less probable to occur.

Another factor that makes it difficult for auditors to provide reasonable assurance over the FVMs, is standards ambiguity. There are IFRS standards related to fair value that contain inherent subjectivity and ambiguity. For example, the fair value estimation of cash-generating items and goodwill impairment involves making many assumptions. It is up to the discretion and professional judgment of the auditor which standard is most appropriate to apply. This increases the task complexity and may reduce audit performance (Wines, Dagwell & Windsor, 2007; Bratten et al., 2013).

2.2.3.2 Task structure

Auditors follow the International Standard on Auditing (ISA) 540 (IAASB, 2008a), which requires them to understand management's decisions, possibly engage a valuation specialist, design substantive tests and evaluate disclosures according to IFRS. Auditing management's decisions involves evaluating the weighting of models selected by management and determining the reasonableness of assumptions underlying those models. However, these models are often unique and complex and the assumptions are subjective. The task of auditing FVMs comprises of multiple aspects and is an unstructured activity because the realization of the auditor's variables is uncertain and there is no clear, universal way of auditing estimates (Bratten et al., 2013).

The uncertain realization often stems from the lag between the moment when an input is observed (when the estimate is made) and the moment it is realized in a following period. This makes FVMs difficult to verify objectively and contributes to the unstructured nature of the task (Earley et al., 2008).

The lack of directional guidance towards an evaluation of the estimate stems from the multiple options for substantive testing that the auditor can select during the audit of fair value and related disclosures. ISA 540 provides three approaches for substantive testing. The first one is testing how management made the estimate by evaluating the management's assumptions and models. The second option is developing an independent point estimate or range. The third

option is a review of events that occur between the financial statement date and the date of the audit report. While having three options, auditors usually apply one single approach (IAASB, 2008a; Bratten et al., 2013). The first option is selected in most of the cases, according to interviews conducted by Griffith et al. (2012).

2.2.3.3 Management Bias

As mentioned above, there is considerable estimation uncertainty inherent to FVMs. Management's assumptions are therefore mostly of a subjective nature. This gives rise to opportunities and incentives for managerial manipulations and biased reporting, which makes the task for the auditors more challenging. Numerous researches have been conducted regarding management's discretion in estimating fair value. In general, the findings reveal opportunistic behaviour by management and auditors failing to detect or correct the bias. The results of Li and Sloan (2011) find that impairments are related to the decreasing performance in the past instead of the present, suggesting that managers delay impairments. Ramanna and Watts (2012) report that management avoids the impairment of goodwill because this could affect remuneration. Hilton and O'Brien (2009) find managerial bias in delaying asset write-downs. Managerial biases can be intentional or unintentional. The audit standard ISA 540 prescribes that during the audit the auditor must constantly be aware of potential prejudices by the client's management, place importance on items with a high probability of misstatement and on items that require substantial subjective judgment (IAASB, 2008a; Singh & Doliya, 2015).

2.2.4 Auditor-specific factors

Besides environmental and task factors that make the audit of FVMs challenging and complex, there are factors specifically related to the auditor that affect the auditor's ability to perform the audit successfully. The auditor-specific factors that are discussed are related to knowledge and expertise and to a lack of professional scepticism.

2.2.4.1 Knowledge and expertise

Many of the deficiencies identified in the PCAOB inspection reports are related to a lack of knowledge and expertise in valuation models. Auditors often do not have the skills required to form an audit opinion on the items reported at fair value (PCAOB, 2012, 2014). In a survey among auditors performed by Griffith et al. (2012), 29 percent said that audit team members

lack knowledge and experience in finance methods to determine the underlying assumptions of the models. 25 percent said that audit team members lack knowledge about management's methods and models in order to determine which assumptions are most important to evaluate the FVM. Thus, staff members with little experience in valuations of fair value are sometimes performing the tests and evaluations of the estimates.

The lack of valuation knowledge makes it difficult for auditors to understand management's assumptions, models and estimates. The auditor may be less able to detect, evaluate and communicate potential concerns about estimates with the parties who were involved with the valuation, such as management or specialists. Auditors have insufficient knowledge and expertise, even though training, guidance and other resources are provided by each of the 'Big Four' firms to increase auditor's knowledge. Acquiring expertise requires training, practice, experience and feedback (Bonner, 2008; Bratten et al., 2013). However, gaining expertise in valuations is more challenging in the audit of FVMs in comparison to other audit areas. According to Laro and Pratt (2005), this is due to the complex nature of valuations and the unique valuation environment in every engagement. In addition, they state that valuation expertise requires skills in multiple areas: financial analysis, management, statistics and economics. Moreover, having experience with one particular valuation, for instance allowances for loan losses, does not mean that this knowledge is equally applicable in another valuation, for example in goodwill impairment.

2.2.4.2 Professional scepticism

Professional scepticism is a characteristic that is critical to any audit. The International Standard on Auditing 200, which formulates overall objectives of the independent auditor, states that an auditor should apply professional judgment and uphold professional scepticism during planning and performing an audit. Professional scepticism is defined as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence" (IAASB, 2008c). However, despite the wide acknowledgement of the need for scepticism in the audit of FVMs, the majority of the auditors does not exercise the desired level of scepticism (PCAOB, 2011; Doliya & Singh, 2016). Professional scepticism is especially important in the audit of FVMs because amounts are uncertain and underlying evidence is often not concrete (Bratten et al., 2013). Backof, Thayer and Carpenter (2016) find that auditors should be better prepared and informed when they need to evaluate a particular assumption of management because it would help in

restraining aggressive reporting. The authors encourage concrete and low-level thinking when evaluating evidence used by management for their assumptions. This way of thinking would make auditors more alert to relevant contradictory evidence. In addition, the authors find that a graphical representation of data and evidence, in comparison to a textual representation, enhances auditors' scepticism for aggressive reporting, as in a graphical representation important relationships between variables can be clearly highlighted.

2.2.4.3 Cognitive limitations and processing demands

Cognitive limitations of the auditor are characterized by increasing processing demands in the audit of FVMs. Processing demands are increasing considerably in the evaluation of dynamic audit standards, various models and many subjective assumptions and are likely to decrease audit performance. Auditors facing increased processing demands are likely to use simplifying processing strategies. To illustrate, an auditor faces multiple challenging factors during the audit of FVMs, such as inherent uncertainty, task complexities and ambiguous standards. With limited abilities, the auditor has to combine multiple and often changing inputs into an uncertain outcome. Consequently, these factors altogether increase processing demands and cause auditors to use a simplified processing strategy to fulfil their task. The downside of these simplifying strategies is that the process of collecting evidence can be negatively influenced. Auditors may fail to correctly evaluate the assumptions of management and specialists and they may overly rely on the assumptions (PCAOB, 2010; Bratten et al., 2013). Besides, as described above, auditors have several options for substantive testing and auditors are tended to prefer the option to test management's assumptions rather than to form an estimate independently (Griffith et al., 2012). This tendency is consistent with the choice for a simplifying strategy in dealing with all challenging factors during the audit. Thus, the deficiency 'cognitive limitations' originates from the interaction between multiple other factors. In other words, increased processing demands can arise from inherent uncertainty and complexities, standard ambiguity and a lack of valuation knowledge and expertise collectively (Bratten et al., 2013).

Appendix I provides an overview of the main findings per deficiency.

3. Methodology

This chapter presents the methodology of this research. The first paragraph describes the research method and the underlying motivation for this method. The second paragraph provides information about the interviews, the primary source of data. This section includes the case description and information about the firm and its employees that are interviewed. The third section presents the secondary source of data, namely document analysis.

3.1 Research method

In this research a qualitative case study is conducted. Qualitative research investigates how individuals interpret their social environment and how they behave in that environment. In this way, a social process or phenomenon can be analysed from the perspective of the individual. Consequently, the obtained information can be described, interpreted and explained (Bleijenberg, 2013; Boeijs, 2014). One type of qualitative research is the case study, a study of a social phenomenon in the natural context of a social system: the case. The researcher describes and explains social processes that evolve between the persons involved in these processes. The researcher focuses on these person's principles, beliefs, opinions, perceptions and experiences (Swanborn, 2013).

A case study suits this research, because the purpose of this research is to gain insight into the audit process of FVMs, the auditors' perception of this process and the deficiencies that are perceived. Therefore, a description and explanation of this process is required, with perceptions and opinions from the auditors as the main source of information. The theoretical concept 'fair value audit' is investigated in a natural environment, a 'Big Four' accounting firm, from the perspective of the individual, the auditor. Besides, despite insights from other studies and efforts of regulators to improve audit performance, audit deficiencies related to FVMs keep on recurring. A better understanding of current audit practices is therefore needed and more insights from auditors themselves are helpful. A case study is an appropriate way to obtain these insights. When employees are answering in their own words to questions of the researcher, it is possible to get to know their specific wording and interpretation about the process or phenomenon.

This research can be classified as an interpretive research, rather than a positivistic research. This study is not about validating knowledge derived from empirical and observable facts, as a positivistic study would entail. So, just pointing out which deficiencies can exist in the audit process, is not the aim of this study. This study tries to understand how the audit of fair value works in reality, by understanding the perceptions and opinions of the auditors

regarding potential deficiencies. Subjective experiences and social interactions are prominent elements within this interpretive approach. The data for this research will be collected through interviews and document analysis (Bleijenberg, 2013).

3.2 Interviews

This research is carried out at KPMG. The firm was founded 100 years ago and is nowadays one of the 'Big Four' accounting firms. KPMG provides services in audit, assurance, tax and advisory, employing approximately 190.000 people in over 150 countries. In the Netherlands there are ten offices with in total almost 3.000 employees. This case study is conducted at the office in Arnhem, where about 60 employees are working (KPMG, 2017c).

To get insight in auditors' perceptions of the audit of FVMs and its deficiencies, two data sources are used. The first source being interviews, conducted at KPMG Arnhem. For this research it is critical to interview employees with experience in auditing fair value. In practice, this means that employees at higher levels in the organization are the ones dealing with fair value measurements. Therefore, only people at higher levels in the organization are interviewed. How an employee can reach these levels, can be explained as follows: university graduates start as Assistant and after two years of attending training and gaining work experience, they are promoted to Senior Assistant. After another year, they are promoted to Supervisor. So years of experience and personal development are key factors for climbing up to other levels of the organization. The KPMG career path is as follows: Assistant - Senior Assistant – Supervisor – Assistant Manager – Manager – Senior Manager – Director – Partner. Managers at KPMG supervise the work of audit teams and coordinate personal development of lower ranked employees. Client projects are assigned to them and they are responsible for these projects. Assistant Managers are one level lower than Managers. Occasionally they are supervising an audit team as well. Senior Managers are experienced Managers that are specialized in their field. They outline the direction of the audit teams and manage cooperation within their client groups. Partners decide the strategy of the firm and its position in the market. Besides, they are responsible and accountable for the overall performance of engagements they are in charge of (KPMG, 2017a). The interviewees of this research are four Assistant Managers, one Manager, two Senior Managers and one Partner. Table 2 shows the level of the interviewees and the date and duration of the interviews.

Job level	Date	Duration
Assistant Manager 1	June 13 th 2017	48 minutes
Assistant Manager 2	June 14 th 2017	59 minutes
Assistant Manager 3	June 21 st 2017	28 minutes
Assistant Manager 4	June 21 st 2017	42 minutes
Manager	June 19 th 2017	54 minutes
Senior Manager 1	June 14 th 2017	33 minutes
Senior Manager 2	June 19 th 2017	43 minutes
Partner	June 14 th 2017	38 minutes

Table 2: Interview information

The interviews are conducted in a semi-structured and open way. The framework of Bratten et al. (2013) is used to structure the interview. This framework presents deficiencies related to the audit of fair value measurements and classifies them in three categories: environmental factors, task factors and audit-specific factors. About each deficiency of the framework some interview questions are formulated. Initially, the order of the deficiencies during the interview was the same as how they are listed in the framework. However, after the first interview there is opted for another order to make the interview run more smoothly and not to switch topics abruptly. During the interviews can be deviated from the questions. For instance, when in depth or extra questions to answers of interviewees could give valuable extra information for this research. Still, the principle order is leading to make sure every respondent gets the same questions and all deficiencies are addressed. In this way, the internal validity of the research is provided. The interview questions can be found in Appendix II.

The interviews are recorded with a voice recorder. Prior to recording the interview, a short introduction is given to the interviewee in order to make him aware of the research he is about to give his input to. This introduction can be found in Appendix II as well. After the interviews have been conducted, they are transcribed manually. Subsequently, the transcriptions are coded according to the code manual presented in Appendix III. The main codes written in capital letters refer to the audit deficiencies of the framework. For each of the deficiencies several keywords are described. These keywords serve as sub codes in the coding process. For instance, if a quote of an auditor relates to the actions he undertakes to detect management bias, the quote is coded with the main code ‘MANAGEMENT BIAS’ and the sub code ‘actions’, resulting in the code ‘MANAGEMENT BIAS actions’. Thus, every coded quote

contains both a main code and a sub code. All coded quotes are copied into an excel file. In this way, the quotes are listed in one file, which enables filtering by deficiency or by keyword. This eases writing down the results of the interviews. An example of a transcribed and coded interview can be found in Appendix IV.

3.3 Documents

The second way data is collected is by analysing documents. Documents may contain specific information about the organization that can be relevant for a qualitative research (Bleijenberg, 2013). The documents used in this study are KPMG Audit Methodologies (KAM). The control approach KPMG applies all over the world is summarized into KAM. The basic idea of this document is to be able to optimally anticipate and respond to changes in the internal and external business environment. Obtained insights in business environment, strategy and processes enable KPMG to determine goals, opportunities and risks of organizations properly (KPMG, 2017b). KAM describes objectives, procedures and methods that can assist auditors throughout the whole audit process. More specific, KAM 020 provides guidance on risk assessment and substantive testing of fair value estimates. Furthermore, auditors can apply KAM to determine whether the work of management's experts can be used as relevant audit evidence.

4. Results

This chapter discusses the results of this research. First, the steps outlined in the audit procedure are described in order to provide a general impression of the fair value audit process at KPMG Arnhem. Then, the results are presented per audit deficiency, according to the sequence of the framework.

4.1 Fair value audit process

This section gives an answer to the third sub question: How can the audit process of fair value measurements at KPMG Arnhem be characterized? The fair value audit process consists of three stages, which are outlined in the KPMG Audit Methodology 020. In this paragraph the audit process is described in a generic way, according to KAM 020. More detailed aspects of the process are addressed in paragraph 4.2, in which specific procedures and actions of the auditors are described mainly based on the interviews with the auditors.

The first stage of the fair value audit is the risk assessment, performed by the engagement partner or manager. Upon accepting the client, significant accounts and disclosures that give rise to a risk of material misstatement are identified. An example of an uncertain account can be a fair value measurement, such as a purchase price allocation or an intercompany loan. An important part of the risk assessment procedure is to understand how management makes the fair value estimates. This includes obtaining an understanding of the valuation model, its underlying assumptions, the degree of estimation uncertainty, whether management has engaged an expert and the relevant controls management put into place.

The second stage is the testing stage, in which procedures are designed and performed in response to the assessed risks of material misstatement. It is determined whether management has correctly applied the requirements of the financial reporting regulations. And it is determined whether the valuation methods are appropriate and applied consistently. In order to do so, the auditor can undertake several actions. Firstly, he can evaluate events that occurred up to the date of the auditor's report to obtain audit evidence. Secondly, he can test how management made the estimate to evaluate the model and the underlying assumptions. Thirdly, the operating effectiveness of the controls over the fair value calculation can be tested. Lastly, to evaluate management's point estimate, he can develop a point estimate or a range himself. Altogether, these testing methods are referred to as substantive procedures.

The last stage is the completion stage, in which it is concluded whether sufficient appropriate audit evidence has been obtained. In the audit report the conclusions of the overall analysis of management bias are documented. Moreover, the conclusions for the fair value estimates that give rise to significant risks are disclosed. Finally, a written representation from management whether they believe the assumptions they used in their fair value calculations are reasonable, is added.

4.2 Audit deficiencies related to fair value measurements

4.2.1 Estimation uncertainty

One of the key characteristics of fair value accounting in comparison to other valuation principles is that the valuation is often based on future estimates. As opposed to fair value accounting, items on the financial statements that are calculated in terms of historical costs are based on the past. These items can be audited relatively straightforward by matching the accounting numbers with underlying evidence, such as invoices or contracts. For items measured at fair value, supporting evidence can hardly serve as hard proof because of the uncertainty involved in estimating future expectations. So what auditors basically do when auditing items measured at fair value is testing management's assumptions. For instance, under IFRS management is obliged to perform every year an impairment test on goodwill, to test whether the current value is lower than the carrying amount. If so, the goodwill must be impaired. To determine the current value of goodwill, the present value of estimated future cash flows has to be calculated. This estimation element causes the outcome to be uncertain, as management subjectively selects the input variables that go into the model of the impairment test. Management has to make assumptions about future growth rates, expected sales, expected cost increases etc. These assumptions are subjective; they are made by personal judgment. The auditors identify estimation uncertainty, caused by the subjectivity inherent to selecting inputs and making assumptions, as a factor that challenges the audit of fair value.

“There is in fact significant judgment in it, much subjectivity. Especially because one can choose between different degrees, different assumptions, it is hard to obtain absolute certainty in such an item.” (Assistant Manager 2)

“Information about the future is difficult to audit. Preferably we want to collect evidence for everything, but what is evidence for future expectations?” (Partner)

One of the methods auditors apply to test management’s assumptions is by comparing them with market information. Whether there is sufficient market information available depends on the item to be measured. To determine, for instance, the fair value of shares an auditor just takes a look at the stock exchange to find the share price. This Level 1 input is directly observable in the market, making the search for reliable evidence relatively easy. However, for some fair value items more effort is required to find comparable information. For example, determining the value of an investment in a non-listed company requires the auditor to go down to level 2 or even level 3 inputs of the fair value hierarchy. Those inputs are based on information derived from market information. They are less observable and therefore less reliable and less certain. In these cases the auditor often asks for assistance to a specialist who has more experience in dealing with complex fair value measurements and more sources of information. In the end, the auditor and the specialist nearly always succeed in determining a proper fair value. Hence, the auditors do not recognize insufficient information as an audit issue. The amount of available information increasing over time eases this process. Although too much information might be a complicating factor.

According to the auditors, uncertainty also arises in times of economic distress. Unexpected events such as wars and natural disasters can significantly affect the economy. They cause market volatility to increase and as a consequence, the risk of errors in valuations increases. Also political changes such as the election of a new president can influence the economy. Another typical example of an unexpected event that caused uncertainty in valuations is the financial crisis of 2008. Hardly anyone predicted the crisis and without an indication for the crisis an accountant does not take it into account in his fair value models.

4.2.2 Regulatory and legal influences

Auditors of KPMG and preparers of financial statements are subject to international accounting standards IFRS and the Dutch national accounting standards issued by the Raad voor de Jaarverslaggeving (RJ). Auditors should also pay attention to International Standards on Auditing (ISA) when performing an audit. The rules have become stricter over the last years. Events in the past, such as accounting scandals, have raised societal and regulatory pressure on

the audit. As a consequence, the audit must nowadays meet higher requirements in comparison to the past. There are higher requirements for underlying evidence and for documentation. Also the audit firm has set higher standards for its audit process.

“Well, society demands it and the supervising body demands it. I think we all know about the scandals in the past, and we want to prevent them from occurring in the future. You can only prevent it by doing your job even better and by applying even more scrutiny.” (Manager)

The auditors perceive stricter rules and requirements and tighter supervision on the audit in general. Specific to fair value there are stricter requirements to the evidence underlying management's assumptions. However, the auditors do not believe there is specific supervision on fair value measurements. The Autoriteit Financiële Markten (AFM) is tasked with supervision on financial audits in the Netherlands. The AFM performs statutory audits on annual financial statements, so if fair value measurements are included in those financial statements there is in fact supervision. However, there is no greater attention specific to fair value measurements than to other items.

IFRS standards are principle-based, prescribing general principles for accountants applicable to a variety of situations. It is a relatively small set of flexible guidelines which leaves room for interpretation and professional judgment by the auditors and preparers of financial statements. The counterpart of principle-based is rules-based. Rules-based standards are more detailed and less open to judgment. However, they are more complicated because it is hard to have all possible situations covered in the standards. The IFRS standards on fair value accounting that the respondents are dealing with, provide a framework outlining the scope in which auditors can operate. The auditors find the standards clear and well-defined, leaving little room for interpretation. However, as fair value measurements are often unique and complex, the standards are generic and do not describe for every situation what steps should be taken. For instance, to determine the value of an asset, IFRS 13 states that an entity should give priority to level 1 inputs from active markets and use appropriate valuation techniques. But, the standard gives only limited examples of possible level 1 inputs and it does not state which valuation technique to apply in which situation. This leaves room for interpretation in the application of the standards in practice.

4.2.3 Audit firm relationships with auditee

The relationship between the audit firm and its client, the auditee, can be roughly divided into two groups. On the one hand, there are client firms that are unskilled in accounting and who do not understand fair value. These firms are mostly relatively small companies that have a financial department with limited capabilities. The person responsible for accounting and financial reporting, in some cases just the chief administrator, lacks sufficient knowledge and expertise to understand why and how an item has to be measured at fair value. He often selects the easiest method, e.g. by just filling in the numbers into the model of last year or by simply stating that the fair value is the same as the book value, instead of challenging and benchmarking the numbers. They might not even be able to fill in the numbers into a model and they see the auditors as experts that come to help. However, if the (internal specialist of the) auditor would make all the assumptions and calculations, there is a risk of self-review. Then the auditor's task is to convince the auditee to engage an external specialist to help them with the valuations.

“There are institutions that have a loan from the bank with an interest rate swap that should be valued separately. These institutions find that nonsense: ‘I have a fixed interest rate of 3% for the next ten years, don’t disturb me because this is for me the most important. I just want a fixed interest rate, which is a good choice from a policy point of view. You are now just having your accounting-technical party.’ ” (Assistant manager 1)

On the other hand, there are client firms that possess sufficient knowledge and skills to be able to deal with fair value. These often larger firms have an audit committee, a valuation specialist or another expert who is able to make and understand calculations and who recognizes the importance of well-established valuations. Still, also skilled auditees may engage an external specialist because fair value measurements are often unique and complex.

When the client firm engages an external specialist, the auditor assesses the external specialist's quality and expertise. Consequently, the report of the client's specialist is audited by the auditor with assistance of his internal specialist. In case the auditor and his internal specialist disagree with the valuation of the client and his external specialist, a discussion between the two parties arises. The auditor asks questions to the auditee to figure out his motivation for making certain assumptions and to detect possible management bias. The auditee argues why his assumptions are reasonable. If the auditee is able to convince the auditor to

share his point of view, no changes are needed. But if the disagreement persists, the auditor can perform a sensitivity analysis to calculate the impact of the auditee's assumptions on the final audit declaration. If the impact is not material, a control difference is reported and that's it. If the impact is material, and thus would result in an audit misstatement, the auditee will make the necessary changes to the assumptions because he would not be eager to explain to his superiors that there is a material misstatement in the financial statements. So ultimately an impasse does not occur. However, this discussion can take a long time and it requires effort and patience of both parties to keep on explaining why certain assumptions are (un)reasonable or (un)realistic.

4.2.4 Audit firm relationships with valuation specialists

Auditors often engage a valuation specialist to assist in the audit of FVMs. As mentioned in the previous paragraph, this is an internal specialist. Internal specialists are employed by KPMG and can be involved in many specialized areas of accounting and finance. The engagement of an external specialist is therefore not necessary, and neither a quality and independence assessment of the specialist is required.

As noted before, auditors immediately call in an internal specialist when the auditee has hired an external specialist. Moreover, specialists are called in when auditors face complex fair value measurements, or they are engaged on efficiency reasons. The specialist deals with valuation issues on a daily basis, possesses specific knowledge, and has access to numerous data sources. He uses considerably less time than the auditor to make a fair value calculation or to evaluate a fair value model. Valuation specialists that are called in most often are the ones specialized in corporate finance. For instance, investments, financial instruments and takeovers are complex items that the auditors are unable to audit alone.

At the start of the engagement, the auditor discusses the fair value issue with the specialist to inform him what is expected of him and which date his findings are needed. When instructing the specialist, the auditor provides him all relevant and information about the client and the market, specific information only the auditor knows. The specialist understands the model and knows the technique to make the calculation, but without the right parameters from the accounting perspective the outcome would not make sense. This requires ongoing coordination and discussion between the auditor and the specialist to make sure the process is efficient and to make sure the outcome is accurate. Disagreement between the auditor and his internal specialist on a particular outcome may arise but has to be solved as they act together externally in meetings with the client and his external specialist.

“For instance, for a goodwill impairment of one of my clients, I have a call next week with the partner and two guys of corporate finance to discuss the meeting with the client. That meeting is only about whether the model the client is going to use meets the requirements, so without the numbers. Subsequently the client gives us a calculation and we will have a meeting about the WACC.² At the end of the year we insert the numbers and we will have two, three more meetings. Altogether, I will have between five and ten meetings.” (Assistant Manager 4)

Moreover, coordination, critical discussion and collaboration between auditor and specialist is important because the auditor is fully responsible for the audit, and therefore also responsible for the specialist’s work. For this reason the auditor also wants to understand the outcome and the considerations of the specialist.

4.2.5 Task difficulty

Whether fair value measurements are perceived as complex depends on which item is to be measured at fair value. The valuation of a machine that can be sold on an active market where comparable transactions are observable (level 1) is quite straightforward. However, auditors regularly see fair value measurements that contain a higher degree of complexity. For the auditors these complex FVMs are difficult to audit because the models and calculations are quite technical and hard to understand. Even if the auditor understands the reasoning behind the calculation, performing tests to evaluate the model can still be challenging. Therefore a specialist is engaged in most of the complex cases. The higher the complexity, the more auditors make use of a specialist.

FVMs can be rather technical and the auditor sometimes does not possess advanced and specialized knowledge to fully understand them. However, according to the auditors, the most important factors that make FVMs complex are uncertainty and subjectivity. When there is little or no market information available and there is no transaction in any market to compare with, it is hard to value an asset or liability at fair value. The item to be measured is in fact unique. This means that there is considerable personal judgment and subjectivity inherent to management’s assumptions and the selected inputs for the fair value calculation. These

² Weighted Average Cost of Capital

assumptions are mostly based on future expectations and involve making estimates, and cause the outcome to be uncertain.

Various items on the financial statement are mentioned as examples of very complex fair value measurements. Intangible assets, such as goodwill and patents, involve significant subjectivity because these are internally developed, thus difficult to benchmark. For instance, when a firm is taking over another firm's business, it is hard to identify and value intangible assets. Also intercompany loans are among the most complex items. These are loans between two affiliated companies and must be measured at fair value because the loan is mostly not taken out in line with market conditions. The same kind of complexity applies to financial derivatives: they can be difficult to benchmark when they are traded over-the-counter (i.e. in a mutual transaction between two parties), rather than on the market. And lastly, the valuations of real estate property held for sale are perceived as complex as well.

“For some areas I wonder what’s the benefit of fair value. It has complicated so much, also in accounting, that actually the users do not understand it anymore. I wonder whether such a complex accounting method is in society’s interest if the average reader does not understand what’s going on.”
(Partner)

The complexity in fair value measurements per se is not increasing over the years. On the one hand, there is more and more information available, so comparing and testing assumptions becomes easier. On the other hand, the audit as a whole is becoming more extensive and more demanding. Requirements on audit evidence and information documentation become stricter, as does the supervision. So there is also more attention to fair value in comparison to a decade ago. An auditor back then could judge whether an assumption was reasonable by using his own professional judgment. Nowadays, evidence and argumentation is required. If, ten years ago, an appraiser would value a building, his findings would be taken over instantly. Nowadays, auditors are more critical, both on the qualifications of the appraiser and on his findings.

To some extent, the standards reduce complexity. The standards provide some guidance in outlining the framework in which auditors can operate. It makes sense that the standards do not describe every possible valuation method because each valuation is unique. Covering everything would make the standard too specific, too large and more complex.

4.2.6 Task structure

The audit of fair value measurements proceeds roughly in three phases. First, the client's model for the fair value calculation is scrutinized. Second, the most important assumptions are addressed and discussed. For example, there should be mutual agreement on the WACC. Third, once the models and assumptions are approved, the numbers are inserted into the model. These steps can be found in more detail in the KPMG Audit Methodology (KAM), which is basically a translation of audit standards such as ISA. KAM 020 provides guidelines for the audit of estimates, including fair value accounting estimates, by describing the steps that should be taken throughout the audit process. The risk assessment stage of the audit includes, among others, the following steps:

- Identify significant accounts and disclosures that contain an estimate when that estimate gives rise to a risk of material misstatement (...).
- Obtain an understanding of how management identifies the need for an accounting estimate.
- Obtain an understanding of the requirements of the applicable financial reporting framework (...) and how management makes the accounting estimates.
- Retrospective review: review the outcome of accounting estimates included in the prior period financial statements (...).
- Management bias: design and perform audit procedures to review accounting estimates for biases (...)

This indicates there is a procedure the auditors follow, meaning that the audit proceeds in a structured way. However, the accounting and reporting standards IFRS, and to a lesser extent RJ, are more generic and therefore provide less structure and leave more room for flexibility. As explained before, they just provide a broad framework, leaving the application of the standards open to professional judgment and interpretation. The standard does not explain how a valuation should be done, so auditors and preparers of financial statements have some freedom in selecting a method. And if they do not possess the knowledge or skills to make a valuation, the audit standards redirect them to a specialist.

“When I’m reviewing my colleague’s work, sometimes I think: I’m still not convinced. Then it’s just my opinion versus his opinion. None of us can point to the regulation and say: ‘this is missing.’ ” (Assistant Manager 4)

ISA 540, and therefore also KAM 020, provide three approaches for substantive testing, two of which are the most common. The first one is testing how management made the estimate by evaluating the management's assumptions and models. The second option is developing an independent point estimate or range. The auditors state that preferably both options are carried out. Fair value measurements are subject to variables that much, that it is critical to do both. Also from within KPMG it is considered important to be critical, think of alternatives and develop your own expectations, in addition to testing the assumptions. In this way anchoring can be prevented. If management lacks knowledge and skills to deliver a decent calculation or even fails to prepare one, the auditor explains them the importance of developing an own model and encourages them to think about the assumptions, eventually to enforce that management has an own calculation and argumentation. It may occur that only management's model and assumptions are tested, for instance, due to efficiency reasons because the model has already been tested and approved in the prior year, or because management's estimates and argumentations are usually well-established and consistent. A choice for only the second option, without testing management's assumptions, rarely occurs.

4.2.7 Management bias

Assumptions and estimates are inherent aspects to the computation of fair value measurements. To calculate the fair value of an asset, management determines the present value of future cash flows. In doing so, it has to make assumptions about future prospects of the firm. This estimation element makes FVMs suitable for managerial bias. Management can influence the outcome by picturing the future brighter than it will be. For instance, if the firm just developed a new product, management of course supports the product, is positive about the potential market and is confident that it will be a success. For auditors this is a difficult situation; perhaps the assumptions are too optimistic, but no historical data is yet available for benchmarking the assumptions. Management can also have personal intentions to present a brighter situation. If their bonus depends on the profit of the firm and one fair value item is highly relevant for the profitability, there is a higher risk for management bias. If the bonus is based on items other than this fair value measurement, the risk of bias is lower.

The auditors are aware of the potential management bias and undertake several actions to detect it. In a retrospective review, the estimates of the prior year can be tested to see how accurate they turned out to be the year after. This gives in an indication on the quality of management's estimates, and whether they are usually optimistic, neutral or conservative.

Furthermore, it is important to figure out the intentions of management in making assumptions. Suppose the auditor has indications that management prefers a low fair value. Then the expected growth rates should also be low, consistent with the lower fair value. Moreover, the growth rates should be somehow consistent with prior years. So the auditor questions the assumptions that reflect the intention of a low fair value and challenges management to understand their intentions and to retrieve answers on possible inconsistencies. If management fails to deliver sound argumentation, there could be a bias. However, management bias is not per definition the result of bad intentions in a sense of earnings management. Maybe management is just unwilling to make changes to a net result they already communicated to their superiors.

“You should always be alert to biases. Of course we are not only auditing fair value items. We have an entire financial audit in which we can notice a trend. If there is management bias, it usually does not concern just one single item.” (Assistant Manager 1)

The aforementioned consistency is a valuable indicator as well, both consistency over the last years and throughout the whole audit. Changing the valuation model or its parameters every year is inconsistent. Assuming for the fair value calculation a 5% growth rate of the firm while a 2% rate is used in the budget for other items, is inconsistent. By performing a sensitivity analysis the impact of a 1% change in the growth rate can be calculated, to see whether it would cause a significant change to the fair value model or to the financial statement as a whole. Lastly, with a corroborative inquiry supporting evidence can be retrieved from other sources, such as an interview with a project leader or a market report of a third party.

4.2.8 Knowledge and expertise

At the start of the audit, the responsible partner or manager completes a questionnaire about the knowledge and expertise of the audit team members to decide whether the FVMs are so complex that a specialist needs to be engaged. Mostly auditors with at least the level Assistant Manager take care of auditing fair value measurements. The easy jobs of the fair value audit can be left to lower employees, including trainees, but always under supervision of someone who understands the model. Due to complexity and their high risk profile, FVMs are often reviewed by multiple audit team members, including often the partner and, of course, the specialist.

Auditing fair value is a process of learning-by-doing. Inexperienced auditors get familiar with fair value by working together with more experienced colleagues who instruct and teach them, and who let them do easy tasks for them. It is important that inexperienced auditors learn to recognize when they are not skilled enough to audit a certain fair value item and that they dare to ask questions to superiors. It is a common misconception that they think they are experienced enough because they already audited it a few times before. Every fair value measurement has unique characteristics and can be complex. Gaining expertise in fair value therefore requires much experience. It is the responsibility of every auditor to ask help to a colleague or a specialist in case something is hard to understand. This also counts for more experienced auditors, although they better know their own limitations and recognize when they need help. It is critical anyway to discuss fair value models and assumptions within the audit team. Not only for a better understanding, but also because it enables auditors to better challenge management.

“You should start with it someday. When it is your first time, you do it together and you act together. It is unacceptable to give a complex item to someone who has never done it before and wish him good luck with it. No, we act together, I let him do a few things and I supervise him.” (Senior Manager 1)

As experience is essential in auditing fair value, it is difficult to train and educate auditors for it. There are mandatory IFRS trainings which are intended to keep auditors' IFRS knowledge updated, but these trainings are rather theoretical. Someone can understand the theory, but putting it into practice is tough. In addition, there are specific internal fair value trainings, but the auditors state they mostly learned-by-doing.

4.2.9 Professional scepticism

Auditors recognize the importance of professional scepticism in the audit of fair value measurements. Even though every item on the financial statement should be audited with a professional sceptical attitude, the presence of management's assumptions and their subjective nature requires greater scepticism. Auditing on the basis of historical costs is straightforward; matching the numbers with an underlying document as evidence. Either it matches, or it does not. Being confronted with assumptions while auditing fair value is different. There is more

uncertainty, more room for bias, more use of someone else's work, and thus more to challenge. Auditors always have to consider what the client's interest and intentions could be.

Besides this intrinsic scepticism of the auditors, scepticism is also enforced by the audit procedure and documentation requirements. Upon accepting a client, the audit firm performs a risk assessment and classifies the client firm as low risk, moderate risk or high risk. In this way, significant risks are identified prior to the audit, so the auditors know which items require more attention and more professional scepticism. Consequently, control measures are performed to mitigate the identified risk. The higher the risk profile, the higher the documentation requirements and the greater the scrutiny of auditors. For instance, for a fair value measurement with a high risk profile an extra quality partner is involved in the audit. The documentation requirements are concerned with how the auditors challenged management's assumptions, whether the relevant issues are discussed and whether there is sufficient underlying information to approve the selected fair value model. KPMG has a professional judgment framework which outlines steps the auditor should take during the audit, including documentation requirements and things to bear in mind while auditing.

PTA (Platform Taxateurs en Accountants), for instance, published 27 points of recommendation for the valuation of real estate. The only reason why PTA was founded was the increasing scepticism in auditing valuations. (...) Society demands something from us, that's why this working group was introduced to design these points. (Manager)

Stricter regulation and pressure from society have caused professional scepticism to increase. A decade ago, the report of a rating agency such as Moody's was taken over as evidence without further scrutiny. Nowadays, auditors are critical on the content of that report, even though it concerns a well-known institution.

4.2.10 Cognitive limitations and processing demands

Despite the multifaceted nature of the fair value audit and complicating factors like the inherent subjectivity and uncertainty, the auditors find themselves capable of performing a high-quality fair value audit. Admittedly, the specialist plays an important role in it. Obviously it depends on the complexity of the fair value calculation whether an auditor needs a specialist. But, as stated before, FVMs are often complex so in most of the cases a specialist is involved. KPMG

is a big firm with many different clients and has a good database for fair value calculations. So together with the specialists the auditors possess the expertise and tools to test the assumptions and give an unqualified opinion in the audit report. Knowing your own limitations and recognizing when a FVM is too complex is critical in this matter.

“I believe we need more accountants that are specialized. Now, our specialists are just experts in financial instruments or real estate. But the translation is difficult: what is the impact of his complex findings on the financial audit, given the materiality? I think more people should focus full time on this translation. (...) To summarize: we need specialists that act as a bridge between the real specialist and the financial audit.” (Senior Manager 2)

In case the auditor is unable to collect sufficient evidence for a particular item, there is the possibility of issuing a qualified opinion or even a disclaimer of opinion. Another option is to postpone the audit report to wait for appropriate information to become available. In that case the deadline is not met, but if there are too many uncertainties left and an important piece of audit evidence is missing, an audit cannot be completed.

The auditor can never provide one hundred percent certainty, but disclosures in the audit report can reduce uncertainty. In the audit report key elements of the audit are explained, often concerning complex estimates relating to fair value. Without going too much into detail, it is described which information was used and which considerations were made to come to a conclusion, and which are the remaining uncertainties.

To what extent the auditors are able to perform a qualitative fair value audit also depends on what users of financial statements expect from fair value. If society expects the reported fair value to become reality, the accountants are not able to provide that certainty. But by disclosing the considerations of the client and the rationale behind the assumptions, tested and approved by the auditors, transparency is provided. With more transparency, the expectations are managed and users will be less disappointed about the outcome.

More emphasis on disclosures and documentation to formalize the audit is a noticeable trend in the last couple of years. The auditors encourage this trend and call for even more formalization, also in the engagement with the specialist. For the future, the auditors attach importance to the use of specialists because there will be more need for experts with specialized knowledge.

5. Analysis

This chapter presents the analysis of the results of this research. In this section, the results of this research are linked with the theoretical background provided in chapter 2. This is done by analysing the results of each deficiency individually and by discussing these results in the light of the findings of the researches discussed in the theoretical chapter. Also it is illustrated how the auditors perceive the fair value audit, whether they perceive audit deficiencies, and how they deal with those deficiencies, e.g. how they prepare, which actions they undertake and how they behave during the audit. Hence, paragraph 5.1 addresses the fourth and fifth sub question:

- How do auditors of KPMG Arnhem perceive the audit of fair value measurements?
- How do auditors of KPMG deal with potential audit deficiencies?

Estimation uncertainty is regarded by the auditors as a factor challenging the audit of fair value. According to the auditors, the inherent subjectivity to the assumptions and models makes fair value measurements difficult to audit and causes the outcomes to be uncertain. This applies mostly to level 3 inputs, which are unobservable and the least reliable, and to a lesser extent to level 2 inputs of the fair value hierarchy. This corresponds with the findings of Bratten et al. (2013), who stated that the subjective nature of level 2 and level 3 inputs cause measurement uncertainty. In contrast to Cannon and Bedard (2016), the auditors of KPMG do not see a lack of sufficient information as a complicating factor. When they are confronted with less observable inputs, they engage a specialist who has access to more sources of information. The specialist is experienced and skilled in fair value measurements. So with the help of the specialist, the auditor nearly always succeeds in auditing the model and the assumptions of the client, and in developing a proper fair value himself. However, the auditors cannot provide one hundred percent certainty. This is in line with Christensen et al. (2012), who stated that no matter the audit effort, there is always uncertainty in FVMs. Lastly, in correspondence with previous research, the auditors recognize macroeconomic risks as a contributor of uncertainty in valuations (IAASB, 2008b; PCAOB, 2011).

Although Hughes and Tett (2008) found improved auditor compliance during the recent crisis, there is little evidence on the effect of regulatory pressure on auditors. The auditors of KPMG state that the audit and accounting standards have become stricter over the last years and identify increased societal and regulatory pressure as causes. The auditors also perceive more supervision on the audit in general. Stricter requirements and tighter supervision indicate that there is regulatory pressure that affects the auditors. However, only stricter rules and

requirements apply specifically to the fair value audit. Fear of litigation was not identified. The accounting standards provide a framework that is clear and well-defined, but for the application in practice the framework leaves room for interpretation, according to the auditors. Even though more detailed instructions on how to measure a fair value account could be desirable, they acknowledge that covering every possible valuation method would make the standard too extensive and complex. The different opinions between auditors and inspectors that were identified by Glover et al. (2015), are therefore not applicable to KPMG's auditors. However, the perceived room for interpretation in the application of IFRS standards is comparable to the concerns about IFRS expressed by Huikku, Mouritsen and Silvola (2017) in their qualitative study on goodwill impairment tests. They state that when readers of financial statements look at goodwill impairment, they should 'see' the economics of the firm's entrepreneurial activities. Instead, goodwill impairment is calculated based on country or industry averages, reports of statistical bureaus rates and negotiated budgets. This makes the calculation more reliable, but firm-specific properties are to some extent not reflected in the calculation. So in order to 'see' the firm, users of financial statements have to look elsewhere around and beyond the firm. According to the authors, this could not have been the intention of IFRS.

Regarding the audit firm relationship with the auditee, the auditors roughly distinguish two groups of auditees: skilled and unskilled in fair value measurements. Both skilled and unskilled auditees may engage external specialists and disagreement and discussion between auditor and auditee arise for both groups as well. Auditors need to put effort in convincing unskilled auditees of the importance of well-established FVMs. Skilled auditees, which are mostly larger firms than unskilled auditees, have more expertise and are therefore better able to make reasonable fair value calculations. Song et al. (2010) found that firms with strong corporate governance have more reliable level 3 fair value estimates. Future research could therefore investigate whether auditees with expertise in fair value have stronger corporate governance. As this was not the focus of this research, it is hard to confirm that. Bratten et al. (2013) state that previous studies report a negative influence of first-mover advantage on audit quality and other studies recognize the auditee-pay model as a source of conflict in the auditor-auditee relationship. However, both first-mover advantage and the auditee-pay model are perceived by the auditors of KPMG as inherent aspects of any relationship between auditor and auditee and it is up to the auditor to exercise professional scepticism, challenge management and detect potential management bias.

The auditors of KPMG frequently engage internal valuation specialists to assist in the audit of fair value measurements. Specialists are mainly called in because of the uncertainty

and complexity of fair value measurements and because of efficiency reasons. Due to the assistance of the specialist, the auditor is able to audit a fair value item. This indicates that the use of specialists has a positive influence on the quality of the audit. In addition, the auditors state that assistance of an external specialist in making assumptions and fair value calculations for the auditee, yields more proper fair values. This indicates that the use of specialists has a positive influence on the quality of financial reporting. These findings are in accordance with Bratten et al. (2013) and Doliya and Singh (2016). Previous research shows that auditors overly rely on third-party specialists (Glover et al., 2015; Pyzoha et al., 2016). Griffith (2016) suggests that this overreliance causes auditors to feel their jurisdictional claim to the audit is threatened. However, these negative effects of the relationship between auditors and external valuation specialists are not applicable to this research. Firstly, because the auditors of KPMG engage internal specialists rather than external. Secondly, because the responsibility for the audit and the work of the specialist lies with the auditor. The auditor therefore places importance on the coordination and collaboration with the specialist and on understanding his outcomes. However, auditor's dependence on specialists is evident.

Whether auditors perceive fair value measurements as complex depends on the item, but they regularly see FVMs with a high degree of complexity. Fair value calculations can be technical and hard to understand and auditors may lack sufficient knowledge to understand these calculations. This is in line with the findings of Bratten et al. (2013). Even if auditors understand the reasoning behind the calculation, testing the model and assumptions can be challenging. This corresponds with the findings of Griffith et al. (2012). They also found that the auditors fail to sufficiently test assumptions and do not recognize which assumptions are most important. The auditors of KPMG admit they are not always able to audit fair values by themselves, which is why ask help to specialists and more experienced colleagues. In this way they make sure there is sufficient expertise within the audit team to test models and assumptions properly. In case the auditor and his specialist develop an own fair value calculation, they may use different assumptions than management, which DeZoort et al. (2003) stated as well. Moreover, DeZoort et al. state that in this case adjustments to management's assumptions are less probable to occur because the auditor would be not able to convince management and the audit committee. However, if the auditors of KPMG perform a sensitivity analysis with management's assumptions and it turns out that the assumptions are unreasonable and cause a risk of material misstatement, management ultimately will adjust the assumptions. The main factor that makes FVMs complex is the subjectivity inherent to management's assumptions, which makes the outcome uncertain. To some extent accounting standards reduce complexity,

as the framework provides some guidance. But there is room for interpretation while applying the standards, which does not always make it easier for the auditors. This is comparable to the standards ambiguity that Wines et al. (2007) identified as a complicating factor.

The KPMG Audit Methodology provides some structure in the audit process because it describes in detail which steps should be taken. Less structure is provided by the aforementioned accounting standards that leave room for interpretation. The lack of a clear, universal way to audit fair value was also identified by Bratten et al. (2013). Regarding the two main approaches for substantive testing, auditors place great importance on performing both tests. In some cases the independent development of an estimate or range is not carried out, which means only the models and assumptions are evaluated. However, in principle both methods are carried out. For this research it can therefore not be argued that having multiple options for substantive testing indicates a lack of directional guidance, as Bratten et al. (2013) in fact argue. Griffith et al. (2012) found that the first option is selected in most of the cases. This corresponds to some extent with the results of this research because the auditors state that only performing the second method rarely occurs.

Numerous researches have showed that managers are opportunistic in estimating fair value and that auditors fail to detect or correct the bias (Bratten et al., 2013). The auditors confirm that managers can be biased and therefore they are constantly alert to the possibility of management bias in the assumptions. This awareness is expressed into several actions the managers undertake to detect managerial bias. By testing estimates of previous years, challenging management to retrieve its intentions, and checking for consistency throughout the whole audit, the auditors try to minimize the risk of not detecting management bias as much as possible. The results of this research do not reveal whether the auditors have failed to detect it. Ramanna and Watts (2012) report that management avoids impairment of goodwill because it would affect their remuneration. The auditors also mention goodwill impairment as an item that may contain managerial bias and they scrutinize manager's salary to check whether their bonuses depend on certain fair value items.

Inspection reports of PCAOB showed that auditors often do not have the skills required to form an audit opinion on fair value items (PCAOB, 2012, 2014). This applies to some of the auditors of KPMG as well. It is critical for these auditors that they ask for help to a colleague or a specialist. Even for auditors that have enough skills and experience in fair value measurements it is important that there is an extra person involved in the fair value audit. Inexperienced auditors get trained for auditing fair value by working together with a more experienced colleague. This might seem comparable to the findings of Griffith et al. (2012),

who state that staff members with little experience are performing tests of fair value items. However, the auditors of KPMG are aware of that, which is why they make sure they instruct and guide inexperienced auditors and closely supervise them. In correspondence with the findings of Laro and Pratt (2005), this research also finds that due to the complex nature and unique characteristics of fair value measurements, gaining expertise in fair value is challenging and requires much experience. Having some experience with the valuation of a particular fair value problem does not mean that one is experienced enough for dealing with another fair value problem.

The subjectivity of management's assumptions, the uncertainty in the amounts and the possibility for managerial bias require a critical attitude of the auditor. The auditors recognize the importance of professional scepticism in the fair value audit, as is also widely acknowledged in literature (Bratten et al., 2013). The auditors exercise professional scepticism not only because they are aware of its importance, but also because it is enforced by KPMG's audit procedure and documentation requirements. Nowadays auditors exercise more scepticism than in the past, which is due to the regulatory and societal pressure. In contrast to the findings of Doliya and Singh (2016) and PCAOB (2011), the results of this research do not show that the auditors fail to exercise the desired level of scepticism.

The tendency, identified by Bratten et al. (2013), that auditors choose for a simplified strategy because they face increased processing demands, is not confirmed by the results of this research. According to PCAOB (2010) and Bratten et al., an auditor faces increased processing demands because the audit of FVMs is complicated by environmental and task factors, ambiguous standards, and the duty of combining multiple and often changing inputs into an uncertain outcome. They also suggest that environmental and task factors interact with auditor-specific factors and that a better understanding of this interaction helps in explaining deficiencies related to the audit of fair value measurements. The findings of this research show that the auditors of KPMG also perceive some of these complicating factors during the audit of FVMs and that these factors are interacting with each other as well. These interactions between deficiencies are identified in order to discuss auditor's perceptions of the fair value audit and the perceived deficiencies as a whole. This is illustrated in the conclusion.

6. Conclusion and Discussion

6.1 Conclusion

This thesis addresses the audit of fair value measurements at KPMG Arnhem. By conducting interviews with auditors that have experience with auditing fair value items, this research investigates how the auditors perceive this audit process and how they deal with the potential audit deficiencies that come forward in the framework of Bratten et al. (2013). Also, data is retrieved from the KPMG Audit Methodology. The results of the interviews and the document review are analysed in order to formulate an answer to the following research question: *How do auditors perceive deficiencies in the audit of fair value measurements?*

The auditors perceive auditing fair value measurement as a complex task. The complexity of the task is to a lesser extent due to the complex and rather technical nature of fair value measurements, but mostly due to the inherent subjectivity in management's assumptions which makes the outcome uncertain. The management of the auditee makes assumptions about future cash flows and growth rates in order to value an asset at fair value. This involves personal judgment and subjectivity of managers and causes the fair value to be an estimate. This estimation uncertainty is therefore perceived as a factor that challenges the audit. To audit management's complex models and assumptions, the auditor often asks help to an experienced colleague or a valuation specialist. The specialist is engaged because the knowledge and expertise of auditors are often not sufficient in order to deal with fair value items. The specialist possesses the required skills to audit fair values and has access to more sources of information to benchmark the assumptions and the model. The auditors do not overly rely on the work of specialists because the responsibility for the audit lies with the auditor. Therefore there is ongoing coordination and discussion with the specialist and the auditor provides him with relevant client-specific information. The auditor retrieves this information by critically challenging management. In this way he tries to understand management's intentions and detect possible management bias. Another important aspect of the interaction with the client is the disagreement about the model or the assumptions that may arise. In case of disagreement between auditor and auditee, a discussion arises in which both parties explain their points of views. This discussion can take considerable time and effort of both parties in order to come to an agreement. Also on the client side there is often the need for a specialist because of the complex and unique nature of fair value measurements. Because of the subjectivity, uncertainty and the room for managerial bias inherent to fair value measurements, a professional sceptical attitude is of great importance in challenging management. The auditors exercise greater

scepticism than roughly a decade ago, because of increased societal and regulatory pressure. Nowadays they perceive stricter requirements and supervision on the audit in general, and to a lesser extent to fair value measurements in specific. Stricter requirements mostly concern the documentation of evidence and disclosures. The auditors encourage this trend, as they believe that transparency can reduce uncertainty. Other alterations to audit and accounting standards are not the solution to reducing uncertainty and complexity. Accounting standards are inevitably generic; including more detailed instructions would complicate the standard. The application of the standards therefore remains open to interpretation. However, this presumed lack of structure in the audit of FVMs is compensated by the detailed audit standards, which are translated into the KPMG Audit Methodology.

To conclude, despite the complicating factors in the audit of fair value measurements, the auditors of KPMG find themselves capable of delivering a qualitative audit, on the condition that assistance of specialists and other (more experienced) audit team members is provided.

6.2 Discussion

6.2.1 Limitations

There are some limitations to this research. The purpose of this study is to gain insights into the audit process related to FVMs, the auditor's perception of this process and the perceived deficiencies. The focus is on the perspective of the auditors, which means that their opinions, experiences and perceptions are leading in this research. However, this can make it difficult for some deficiencies to emerge in this study. According to literature, some of the deficiencies of the framework are partially related to auditor failure. For instance, regarding management bias, previous research shows that auditors fail to detect or correct the bias. In addition, there are studies stating that auditors might not exercise the desired level of professional scepticism. Even though a few interview questions were related to these issues, the results of this study do not reveal whether the auditors fail to detect managerial bias or fail to exercise sufficient professional scepticism. With the purpose of this study in mind, the perception of the auditor being of central interest, it is less likely that auditors would admit their own failure during an interview, apart from the possibility that the auditors do not fail at all. However, the results of this study show that auditors place great importance on professional scepticism in the audit of fair value items. Moreover, they recognize opportunities for managerial bias as one of the main complicating factors to the audit. Thus, it can be concluded that these deficiencies are perceived,

thereby contributing to the purpose of this study. Besides, the results of other deficiencies show that the auditors were open and honest during the interviews. For example, they recognize their lack of knowledge and expertise and their dependence on specialists.

Another limitation of this study is the selection of respondents. Only auditors with quite some experience in auditing fair value measurements were selected. There is opted for experienced auditors because of the higher probability that they are familiar with (almost) all aspects of the fair value audit, e.g. testing assumptions, interacting with the specialist, challenging management. An auditor who occasionally performed some straightforward audit work under supervision of an experienced colleague, in fact also has experience with auditing fair value items, but his experiences would be less valuable for this study. Even though the respondents were all experienced, there were still differences among them. The tenure of the respondents ranged from 5 to 22 years and the amount of experience with auditing fair value differed much as well. However, the results are representative for KPMG Arnhem as these respondents were basically the auditors with most experience in auditing fair value measurements.

6.2.2 Suggestions for future research

Regarding the audit of fair value measurements, there are still opportunities for further research. The findings of this research are representative for KPMG Arnhem. This research can be carried out in other offices as well. For KPMG it could be interesting to see whether the auditors in other offices perceive the audit of fair value measurements and the related deficiencies in the same way. For scientific reasons it can be valuable to investigate this topic in other accounting firms, in other cities and in other countries, in order to get a better understanding of the auditor's perspective regarding the fair value audit.

The results of this research show that auditors are often dependent on the help of valuation specialists. Some of the auditors foresee an even greater role for the specialist in the future, because of increasing complexity and a more demanding audit. Insights from the perspective of the specialists can therefore contribute to the understanding of the fair value audit in its deficiencies.

Lastly, the findings of this study show that auditors find that IFRS standards on fair value provide a well-defined generic framework, but that application of the framework in practice is open to interpretation. Some auditors miss detailed instructions on how fair value measurements should be calculated. Also Huikku et al. (2017) express concerns about IFRS,

stating that the calculation of goodwill impairment under IFRS yields industry averages, rather than the intended firm-specific values. Future research could be focused on ways to improve IFRS standards in order to make them achieve their initial purposes and in order to provide more guidance for auditors.

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Appendices

Appendix I: Overview findings per deficiency

	Main findings
Environmental factors: Estimation uncertainty	Estimation uncertainty inherent in complex FVMs equals or exceeds the tolerable materiality level in >70% of the cases. Lack of sufficient and reliable information is a key factor for high uncertainty. Regardless of audit effort, there is always significant inherent uncertainty in reported amounts that are determined by management's models. Less reliable fair value measurements and a more challenging fair value audit as results of macroeconomic events.
Regulatory and legal influences	Regulatory pressure might create incentives for auditors to increase the quality of the audit of FVMs. During the financial crisis auditors' compliance improved due to stricter supervision and fear of litigation. Different opinions between audit experts and inspection experts regarding the inspection of complex FVMs.
Audit firm relationships with auditee	First-mover advantage and auditee-pay model negatively affect audit quality (no evidence on audit of FVMs in particular). Firms with strong corporate governance have more reliable level 3 fair value estimates. Auditor receives less support from audit committee in case of disagreement about estimates.
Audit firm relationships with valuation specialists	Positive effects of the use of pricing services on the quality of audit and financial reporting. Auditors occasionally overly rely on third-party specialists. Auditors feel specialists ultimately threaten their jurisdictional claim to the audit. Defensive behaviour arises.

Task factors: Task difficulty	Auditors sometimes do not understand management's assumptions underlying the estimate. Auditors with expertise may use different assumptions when developing estimates than management's specialists do. Complexity increases due to inherent subjectivity and ambiguity in standards.
Task structure	Lag between moment of observation and realization of an input contributes to the unstructured nature of the audit. Lack of directional guidance because of multiple options for substantive testing.
Management bias	Opportunistic behaviour by management occurs and auditors fail to detect or correct the bias. Management avoids the impairment of goodwill. Managerial bias in delaying asset write-downs.
Auditor-Specific factors: Valuation knowledge and expertise	Sometimes staff members are performing tests and evaluations of the estimates while they lack knowledge and expertise. Gaining expertise in valuations is more challenging in the audit of FVMs in comparison to other audit areas.
Professional scepticism	Majority of the auditors does not exercise the desired level of scepticism. Auditors should be better prepared and informed for evaluating assumptions of management in order to limit aggressive reporting.
Cognitive limitations and processing demands	An auditor faces multiple challenging factors during the audit of FVMs, which increases processing demands. Auditors facing increased processing demands are likely to use simplifying processing strategies. This negatively affects evaluation of evidence.

Appendix II: Interview questions

Introductie

Goede morgen/middag. Bedankt dat ik je mag interviewen en alvast bedankt voor je medewerking aan dit interview. Ik ga je dadelijk een aantal vragen stellen over de audit van fair value waarderingen, maar ik zal eerst kort uitleggen waarom ik dit doe. Ik ben masterstudent Accounting & Control en ik schrijf momenteel mijn eindscriptie als scriptant bij KPMG Arnhem. Het doel van mijn onderzoek is inzicht krijgen in hoe auditors de audit van fair value waarderingen ervaren. De literatuur beschrijft een aantal tekortkomingen met betrekking tot de audit van fair value, de zogeheten 'audit deficiënties'. Voorbeelden hiervan zijn dat de waarderingen nogal complex zijn, een hoge mate van schattingsonzekerheid bevatten, en dat managers subjectieve keuzes maken bij het waarderen tegen fair value. Deze deficiënties kunnen betrekking hebben op de auditor, maar ook op eigenschappen van de audit zelf of de audit omgeving. Door jou een aantal vragen te stellen met betrekking tot deze deficiënties, probeer ik een beeld te krijgen van hoe auditors deze deficiënties ervaren, of ze zich erin herkennen, of misschien wel juist niet. Mochten er vragen niet duidelijk zijn of heb je verdere toelichting nodig, laat dit dan even weten. Als verder alles duidelijk is, dan kunnen we nu beginnen met het interview.

Interviewvragen

Kun je om te beginnen iets over jezelf vertellen?

- Naam.
- Leeftijd
- Hoe lang ben je al bij KPMG in dienst?
- Hoe lang heb je al ervaringen met fair value waarderingen
- Kom je het vaak tegen?

Environmental and Task factors

Task difficulties

- Kom je wel eens fair value waarderingen tegen die niet eenvoudig te controleren/te auditen zijn?
 - o Wat maakt fair value waarderingen zo complex?
 - o Welke stappen onderneem je als je ingewikkelde waarderingen tegenkomt?

- o Welke hulpmiddelen zijn er beschikbaar?
- o Wat zijn volgens jou posten waarbij het waarden tegen fair value het meest complex is en het moeilijkst om te auditen?
- Dragen de regels en richtlijnen m.b.t. de audit van fair value bij aan het beter begrijpen van fair value waarderingen en de onderliggende aannames van management?

Structuur

- Verloopt de audit van complexe fair value waarderingen volgens een bepaalde structuur?
 - o Kun je flexibel zijn in je aanpak of is elke audit van fair value waarderingen gehecht aan een vaste procedure?
 - o Of is het een dusdanig veelzijdige bezigheid dat het elke keer weer anders is?

Regulatory and legal influences

- Welke regels dienen er gevolgd te worden tijdens de audit van complexe fair value waarderingen?
 - o Reporting standards, audit standards. Nederlandse audit standards 3400?
 - o Hoe ervaar je deze regels?
 - Zijn de standaarden duidelijk? Komt het wel eens aan op uw eigen oordeelsvorming/interpretatie bij de keuze welke standaard gehanteerd moet worden?
 - Vind je dat de regels hun doel bereiken? Zijn de regels/standaarden realistisch? (of is het lastig om aan de voorgeschreven materialiteitsniveaus te voldoen?).
- Wordt er specifiek toezicht gehouden op de audit van fair value?
 - o Hoe ervaar je dit toezicht?
 - Ervaar je druk vanuit de toezichthouder?
- ISA 540 reikt verschillende benaderingen aan voor substantive testing. Ben je daarmee bekend? De 2 hoofdbenaderingen zijn:
 - Testen van de assumpties van het management
 - Zelf een onafhankelijke schatting maken
- o Hoe wordt bepaald voor welke benadering er wordt gekozen?

- Welke van de twee methodes wordt het meest gebruikt?
- Merk je dat er door deze factoren vaker gekozen wordt voor een eenvoudige strategie bij het auditen van fair value waarderingen?
 - o Wordt er vaker gekozen voor testen van de assumpties van het management in plaats van dat er zelf een onafhankelijke schatting wordt gemaakt?

Estimation uncertainty

- Hoe wordt bepaald welke waarderingsmethode gebruikt dient te worden bij een complexe fair value waardering waarvan de regelgeving meerdere mogelijke methodes voorschrijft?
 - o Is het duidelijk welke methode/model er gebruikt dient te worden?
- Welke informatie gebruik je om tot een fair value waardering te komen met een hoge mate van onzekerheid en complexiteit?
 - o Hoe worden inputs/variabelen voor modellen en waarderingen geselecteerd wanneer er een bepaalde keuzevrijheid is?
 - o Is er genoeg informatie beschikbaar?
 - o Hoe wordt bepaald van welk niveau van de fair value hiërarchie inputs worden gebruikt?
 - Is daar wel eens een verschil van mening over, bijvoorbeeld over de keuze tussen level 2 en 3 inputs?
- Merk je dat het steeds moeilijker wordt om de betrouwbaarheid van fair value waarderingen te garanderen?
 - o Zijn er voorbeelden van situaties waarin het waarderen tegen fair value nog meer onzekerheid met zich meebrengt of nog complexer is dan normaal?
 - Macro-economische schok

Relaties met externe partijen

- Relatie met de klant:
 - o Hoe kijkt u aan tegen de relatie met uw klant m.b.t. fair value waarderingen
 - Zijn er voorbeelden van problemen of conflicten tussen de auditors en de klant m.b.t. fair value waarderingen? Audit commissies.

- Hoe wordt er omgegaan met eventuele meningsverschillen over fair value waarderingen?

Management vooroordelen:

- Er is veel onzekerheid in de schattingen. Assumpties van het management zijn vaak subjectief van aard. Hoe ga je om met deze subjectiviteit?
 - o Hoe ga je om met de mogelijkheid van management bias?
 - Ben je extra alert op mogelijke bias van managers?
- Merk je dat managers bewust dan wel onbewust biased zijn in hun waarderingen?
 - o Waarin uit zich dit?
- Zijn er items die extra aandacht vereisen omdat er een hoge kans is dat management subjectieve oordeelsvorming toepast bij hun waarderingen?

Relatie met specialist

- Wordt er beroep gedaan op externe waarderingsspecialisten?
 - o Frequentie
- Kun je beschrijven hoe de interactie verloopt?
 - o Instrueer je ze, begeleid je ze, of geef je hen de vrijheid?
- Hoe gaat u om met het werk dat zij leveren?
 - o Bent u het met ze eens?
 - o Onderling vertrouwen

Auditor-Specific factors

Kennis en expertise in fair value waarderingen:

- Hebben de mensen in het audit team die zich bezighouden met fair value waarderingen volgens u voldoende ervaring en kennis op dit gebied?
 - o Komt het wel eens voor dat iemand ermee bezig is die er niet genoeg kennis en ervaring bezit?
- Het waarden tegen fair value is veelzijdig en vereist kennis van meerdere aspecten: economie, statistiek, financiële analyse, management.
 - o Hoe wordt je bij KPMG hierop voorbereid?
 - o Hoe heeft u deze kennis opgedaan en hoe werd u voorbereid op fair value waarderingen: training, studie?

- Hoe kijk je aan tegen de audit van fair value waarderingen in vergelijking met de audit van andere items?
 - o Wat is het belang van ervaring bij het auditen van complexe fair value waarderingen in vergelijking met de audit van andere posten?

Professioneel kritische houding:

- Wat is het belang van een professioneel kritische houding bij de audit van complexe fair value waarderingen in vergelijking met de audit van andere items?
- Merk je dat andere leden van het audit team die betrokken zijn bij fair value waarderingen een extra professioneel kritische houding hebben?

Cognitieve beperkingen:

- De audit van fair value is een veelzijdige bezigheid. Daarnaast moet er veel informatie verwerkt worden: aannames van management, regelgeving, vele waarderingsmodellen. Daarnaast zijn er factoren als onzekerheid en complexiteit die de audit van fair value lastiger maken. Vindt u dat het binnen de mogelijkheden van de auditor ligt om een kwalitatief goede audit te verrichten?
- Tot slot: Wat zouden verbeteringen kunnen zijn om de kwaliteit van de audit van fair value te verhogen?

Appendix III: Coding table

Code: PROCESS

Keyword	Description
PROCESS	Steps in the fair value audit process.

Environmental factors

Estimation uncertainty

Code: UNCERTAINTY

Keyword	Description
Measurement	The absence of a general agreed-upon method for the valuation or estimation of an item on the financial statement.
Subjectivity	Personal judgment involved in selection of models and inputs.
Fair value hierarchy	Level 1, level 2 and level 3 inputs.
Information	Information that is used for selecting input variables and testing assumptions.
Macro-economic shock	Unpredictable event that significantly affects the economy challenges the fair value audit.

Regulatory and legal influences

Code: REGULATOR

Keyword	Description
Pressure	Rules and standards of regulating and standard setting bodies are stricter due to scandals in the past.
Supervision	External oversight on the audit of FVMs.
Guidance	Opinions of auditors on standards.

Audit firm relationships with auditee

Code: AUDITEE

Keyword	Description
Skilled	Responsible persons for financial reporting at client firm are skilled and experienced in fair value.
Unskilled	Responsible persons for financial reporting at client firm lack skills and experience in fair value.
Specialist	The auditee engages a specialist to assist in the calculation of the fair value item.
Disagreement	Auditee and auditor disagree on a fair value model or its assumptions.
Discussion	Auditee and auditor argue why a certain fair value model or assumption is (un)reasonable.

Audit firm relationships with valuation specialists

Code: SPECIALIST

Keyword	Description
Engagement	Auditor engages an internal specialist to assist in the audit of fair value measurements.
Interaction	An ongoing process between auditor and specialist by giving instructions, discussing and evaluating outcomes.
Understand	The auditor wants to understand the outcome of the work performed by the specialist.
Responsible	While engaging a specialist, the auditor remains responsible for the audit.

Task factors

Task difficulty

Code: DIFFICULTY

Keyword	Description
Complex	Auditors find fair value measurements complex.
Models and assumptions	Models to calculate fair value and underlying management's assumptions are complex.
Factors	Uncertainty and subjectivity are, among others, factors that make the fair value assessment complex.
Standards	To some extent standards help in reducing complexity.
Items	Auditors identify items on the financial statement measured at fair value that contain a high degree of complexity.
Increasing	Fair value measurements become more complex over the years.

Task structure

Code: STRUCTURE

Keyword	Description
Procedure	Auditors are subject to a fixed procedure when auditing fair value.
Judgment	Standards leave room for professional judgment and interpretation.
Substantive testing	ISA 540 provides two main approaches for substantive testing a FVM: (1) testing management's assumptions and (2) developing an independent point estimate or range.

Management bias

Code: MANAGEMENT BIAS

Keyword	Description
Assumptions	Management's assumptions underlying FVMs are subjective by nature and leave room for bias.
Consistency	Auditors pay attention to consistency in reporting throughout the whole financial statement, and to consistency over the last couple of years.

Items	Auditors identify items with opportunities for managerial bias.
Actions	Auditors undertake actions and demonstrate certain behaviour to detect management bias.

Auditor-Specific factors

Valuation knowledge and expertise

Code: KNOWLEDGE AND EXPERTISE

Keyword	Description
Team	Audit team members deal with fair value measurements.
Insufficient	Auditor lacks knowledge/expertise to understand fair value measurements.
Experience	Auditing fair value is a process of learning-by-doing.
Training	There are trainings related to fair value.
Help	Auditors ask help to more experienced colleagues or to specialists when they are not able to audit fair value on their own.
Compare	The importance of experience in fair value audits compared to non-fair value audits.

Professional scepticism

Code: SCEPTICSM

Keyword	Description
Importance	Auditors' views on the importance of professional scepticism for auditing fair value.
Extra	Auditors (do not) exercise more professional scepticism when they face an item measured at fair value.
Compare	The importance of scepticism in fair value audits compared to non-fair value audits.

Cognitive limitations and processing demands

Code: COGNITIVE

Keyword	Description
Ability	The ability of the auditor to perform a qualitative fair value audit.
Simplified	The choice for a simplified strategy because of increased processing demands.
Improve	Suggestions to improve the quality of the fair value audit.

Appendix IV: Coded interview transcript

Interview Senior Manager 1

24-06-2017

Kun je om te beginnen iets over jezelf vertellen. Je naam, leeftijd, hoe lang je werkzaam bent bij KPMG en hoe vaak je in aanraking komt met fair value waarderingen?

Ik ben [naam], 36 jaar, ruim 12,5 jaar werkzaam bij KPMG in de audit. Ik heb zowel klanten onder Dutch GAAP als IFRS. Hoe vaak kom ik in aanraking met fair value? Ik kom het in ieder geval op jaarbasis tegen maar niet bij al mijn klanten in grote complexiteit. Ik heb wel een paar klanten waar een overname heeft gespeeld het afgelopen jaar en daar is fair value assessment een belangrijk onderdeel van. Dus ik kom het regelmatig tegen.

Kom je wel eens fair value waarderingen tegen die niet zo makkelijk te controleren of niet zo makkelijk te auditen zijn?

Ja. Ik denk met name bij overnames waar je al dan niet aandelen of de business overneemt van een andere partij. Dan komen een aantal immateriële vaste activa naar voren en de waardering daarvan is in ieder geval complex, zowel het identificeren als het waarderen daarvan. En de waardering van derivaten zijn ook complex.

Commented [JCd(1)]: DIFFICULTY items

Wat maakt fair value waarderingen zo complex?

Het is denk ik heel specialistisch. Hoe bepaal je de waardering van een immaterieel vast actief? Wij hebben daar in mijn studie geen modellen van meegekregen hoe je dat zou moeten controleren. Hoe je überhaupt een waardering kan bepalen, laat staan hoe je hem controleert. Dus binnen KPMG hebben we daar echt specialisten voor opgeleid, binnen KPMG zit Corporate Finance en conculega's in andere kantoren hebben soortgelijke afdelingen. Dat zijn mensen die dagelijks bezig zijn met de waarderingsvraagstukken van complexe zaken. En dat kan zijn een klantenlijst, een patent, een derivaat als onderdeel van een financieringsovereenkomst. Wij beschouwen dat echt als een specialisme.

Commented [JCd(2)]: DIFFICULTY factors

Commented [JCd(3)]: KNOWLEDGE AND EXPERTISE insufficient

Commented [JCd(4)]: SPECIALIST engagement

De stappen die je onderneemt als je zo'n ingewikkelde waardering tegenkomt, is de gang naar de specialist? Of zijn er ook nog andere ...?

Hangt er een beetje van af. Als het gaat om complexe zaken dan haak je de specialist al vrij snel aan. Op het moment dat er bij een klant van mij sprake is van een overname, en een klant deelt dat mede, dan is de eerste vraag die ik aan de klant stel: welke specialist schakel jij in? Schakel je ze in en zo ja, welke? Zo niet, waarom niet? En met name op het moment dat je een business overneemt, daar komen vaak synergievoordelen uit, er zit een klantenlijst aan ten grondslag, patenten kunnen erin zitten, technologie kan erin zitten. Dan is de eerste vraag: hoe ga je dat zelf waarderen? Ik kan het niet, ik vind het heel complex. Klant, ben jij in staat om daar zelf een waardering aan toe te kennen? Negen van de tien keer geeft ook de klant aan dat hij dat niet kan. Dat betekent dat zij vaak een specialist gaan inschakelen. Dan zeg ik dat ik het goed vind dat hij dat aangeeft. En dat is het moment waarop ik mijn specialist ga inschakelen. Vroegtijdig, eigenlijk voordat wij inhoudelijk aan de slag kunnen. Er is sprake van een overname, de klant neemt een specialist in de arm voor de waardering van met name immateriële vaste activa en het identificeren daarvan. Haak aan, wordt onderdeel van het team en we gaan een plan van aanpak bepalen. Dus ik doe dat eigenlijk op het moment dat de klant mij belt en zegt: "we hebben een overname gedaan," dan hebben we binnen no time de specialist in ieder geval aangehaakt.

Commented [JCd(5)]: SPECIALIST engagement

Commented [JCd(6)]: DIFFICULTY complex

Commented [JCd(7)]: AUDITEE specialist

Commented [JCd(8)]: SPECIALIST engagement

Dragen de regels en richtlijnen m.b.t. de audit van fair value bij aan het beter begrijpen van fair value waarderingen? Bieden die houvast?

Die bieden wel houvast in dat ze aangeven hoe je het zou kunnen bepalen. In de RJ geven ze netjes aan op welke manieren je per post een reële waarde zou kunnen bepalen. Als je kijkt naar IFRS dan gaat het nog verder. Dat geeft ook wel aan dat het lastig te begrijpen regels zijn, met name als het gaat om financiële instrumenten en de reële waarde daarvan. Dat geeft wel aan dat het complex is. Het is niet voor niks dat wij er altijd zo'n specialist bij hebben. Een financial instrument specialist, dat hebben we niet voor niks. Als je dat erbij doet en je doet het af en toe, je komt het een keer tegen uit hoofde van een overname of een nieuwe financiering, dan moet je elke keer opnieuw door al die regels heen om te bepalen hoe je het eigenlijk kan bepalen. Dan krijg je een berekening van de klant. Hoe goed kunnen wij die berekening zelf begrijpen als je er maar een keer per jaar mee bezig bent? Dat is voor mij ook altijd een reden. Ik kan het zelf proberen te ontdekken, of ik schakel een specialist in die er dagelijks mee te maken heeft. Ik vind de regels onder RJ iets eenvoudiger dan onder IFRS, maar in beide gevallen kan het behoorlijk complex zijn.

Commented [JCd(9)]: DIFFICULTY standards

Commented [JCd(10)]: DIFFICULTY models and assumptions

Commented [JCd(11)]: DIFFICULTY standards

Bieden die regels een bepaalde structuur?

Voor het controleren van de reële waarde?

Ja.

Hangt af van de post denk ik. In hoofdlijnen vind ik het vrij breed beschreven. Dus dat wil zeggen dat ze wel aangeven dat je een actieve markt benadering kan toepassen, of een bepaald model waarmee je toekomstige kasstromen gaat bepalen. Maar het staat niet in de literatuur, althans niet in onze wetgeving, dit model je moet je toepassen en zo is het model vormgegeven. Dus er is vrijheid.

Commented [JCd(12)]: STRUCTURE judgment

Dus er zijn mogelijkheden tot eigen oordeelsvorming in het toepassen van die regels?

Zeker, en je kan kiezen tussen modellen. Het is ook heel lastig. Bij voorkeur heb je een actieve markt tussen derden, dat is het meest eenvoudig want dan kun je soortgelijke transacties toetsen. Dan kun je zien: waarom wijkt deze waardering af? Maar dat is natuurlijk niet in alle gevallen aanwezig.

Commented [JCd(13)]: STRUCTURE judgment
UNCERTAINTY measurement

Je bedoelt die hiërarchie?

Bijvoorbeeld, ja. Onder IFRS heb je de hiërarchie. Daarnaast, op het moment dat je toekomstige kasstromen moet gaan bepalen, om die contant te maken om de reële waarde van een asset te bepalen, daar zit een schattingselement in, daar zit een toekomstelement in. Het moet zich nog gaan voordoen. Daar zitten dus ook zeker vanuit de klant zijde zaken die je zou kunnen beïnvloeden.

Commented [JCd(14)]: UNCERTAINTY fair value
hierarchy

Commented [JCd(15)]: UNCERTAINTY subjectivity
MANAGEMENT BIAS assumptions

Vind je dat de regels hun doel bereiken? Zijn de regels/standaarden realistisch?

Op zich wel, maar ze zijn wel complex. Ik bedoel als zowel de accountant bepaalde zaken niet meer zelfstandig kan controleren en een specialist moet benoemen, maar ook aan de kantzijde moet je specialisten inschakelen, dan weet je in ieder geval dat het complex is. Dan is de uitkomst voor veel mensen lastig te begrijpen. Dat is dan een gegeven waar je maar van uit

moet gaan dat het klopt. Doordat je complexe regels hebt, vraag ik me wel af of de lezer van een jaarrekening in alle gevallen eigenlijk nog begrijpt wat er dan staat. Als we het zelf al nauwelijks kunnen bevatten en bepalen. In sommige gevallen slaat het zijn doel nog wel eens voorbij denk ik.

Commented [JCd(16)]: REGULATOR guidance
DIFFICULTY standards

Wordt er specifiek toezicht gehouden op de audit van fair value waarderingen?

Toezicht vanuit?

Extern.

Niet specifiek op fair value. Uiteindelijk geven wij een verklaring af bij een jaarrekening of een andere set van cijfers. Als daar onderdeel van is dat iets qua grondslag op fair value moet worden bepaald, dan ben je ook onderhevig aan hetzelfde toezicht. Maar het is niet een specifiek aandachtspunt, zo heb ik het in ieder geval niet ervaren, dat een toezichthouder specifiek gaat kijken hoe wij de fair value hebben gecontroleerd op bepaalde posten.

Commented [JCd(17)]: REGULATOR supervision

Ik weet niet of je bekend bent met ISA 540, International Standard on Auditing.

540 is?

Daarin worden benaderingen aangereikt voor substantive testing. De twee hoofdbenaderingen die zij aanreiken zijn het (1) testen van assumptions van management, en (2) het zelf ontwikkelen van een onafhankelijke schatting. Hoe wordt die keuze daartussen gemaakt?

Ik denk dat je ze allebei moet doen.

Altijd?

Ik probeer ze altijd toe te passen allebei. Wij controleren iets dus het management heeft al een standpunt ingenomen. Maar als onderdeel van het toetsen van die assumptions van het management, is het goed om daarnaast je eigen verwachting daar tegenaan te houden. Dus om management assumptions te kunnen toetsen moet je eigenlijk ook een eigen verwachting hebben om te voorkomen dat je aan anchoring doet. Dus dat je eigenlijk evidence zoekt bij het standpunt van het management.

Commented [JCd(18)]: STRUCTURE substantive testing

Dat je op zoek gaat naar die bevestigende ...

Bevestiging. Ik denk dat het ook goed is dat je kijkt, los van wat het management vindt, wat had ik nou zelf verwacht. En in sommige gevallen is dat lastig als het gaat om toekomstige rentabiliteit of winstgevendheid van de onderneming. Dan is het management natuurlijk over het algemeen wat beter in staat, die kent de markt ook beter, die is daar dagelijks actief in, dan dat wij dat als accountant zijn. Maar aan de hand van brondocumentatie, of rapporten van derden over de markt an sich, of schattingsposten in het verleden: is het management altijd optimistisch, redelijk neutraal of conservatief in schattingen? Zo heb je natuurlijk wel aanknopingspunten om de inschattingen van het management te bevragen en te challengen. Ik zie het als een combinatie van beiden.

Commented [JCd(19): DIFFICULTY models and assumptions

Commented [JCd(20): MANAGEMENT BIAS consistency

Dus er wordt niet vaker gekozen voor het alleen maar testen van die assumptie omdat je er dan eenvoudig van af kan maken?

Ik zou niet willen zeggen "eenvoudig van af maken". Startpunt is wel dat je iets van het jij iets van het management krijgt, dus je bent wel geneigd, en dat is denk ik ook natuur eigen, om te kijken of je snapt wat daar gebeurt. Ongetwijfeld komt het voor dat op het moment dat je het herkent, snapt en het in een context kan plaatsen, dat je minder kritisch bent om er nog een alternatief tegenaan te plakken. Dat begrijp ik. En stel je voor dat het management in de regel vrij betrouwbaar kan schatten, en het is een goed onderbouwd verhaal, dan denk ik dat die tweede stap in veel gevallen wel een hele lichte vorm zal hebben.

Commented [JCd(21): COGNITIVE simplified STRUCTURE substantive testing

Bij complexe fair value waarderungen waar meerdere waarderingsmethodes mogelijk zijn om te kiezen, is het dan duidelijk welke methode er gebruikt dient te worden?

Hangt van de post af.

Bij de complexe vooral, dus bij immateriële vaste activa bijvoorbeeld.

Je hebt daar keuzemogelijkheden in. Is het duidelijk waaruit je kan kiezen? Ja. Is er een duidelijke voorkeur? Niet in alle gevallen.

Commented [JCd(22): UNCERTAINTY measurement

En hoe wordt die keuze dan gemaakt?

Juist bij dit soort complexe dingen schakelen wij onze specialist in, die laten wij het model toetsen. Maar een van de eerste vragen is: is het een acceptabel model? En als het antwoord ja is, waarom dan? Waarom vinden we dit een acceptabel model? Die mensen zien zo ontzettend veel overnames, juist op deze specifieke onderdelen, dat zij al kunnen aangeven of dit een veel voorkomend of veel gebruikt model is, die theoretisch ongetwijfeld als een van de opties wordt aangereikt. Ik wil niet zeggen dat daar mijn verantwoordelijkheid stopt, maar ik heb niet de kennis en kunde om de zes modellen die er misschien zijn, op te kunnen dreunen. Dus ik beleg dat heel bewust vooraf met de specialist: daar moet je naar kijken want daar heb ik geen verstand van.

Commented [JCd(23)]: SPECIALIST engagement

Commented [JCd(24)]: SPECIALIST responsible

Commented [JCd(25)]: KNOWLEDGE AND EXPERTISE insufficient

En als je het hebt over de inputs van de assumpties, heb je genoeg informatie beschikbaar?

Uiteindelijk wel. Als mijn specialist in mijn team zegt: het model is goed en je moet er de volgende variabelen instoppen, dan is over het algemeen de afspraak dat de specialist met name kijkt naar de techniek, en werkt het rekenmodel wel goed uit? Maar de input die er in gaat in grote mate, daar kijken wij naar. Dus als het gaat om budget en forecast van variabelen, daar kijken wij naar, maar wel in samenspraak met de specialist, want zij zien alleen al of er in de mechaniek van het model en de uitkomst eventuele bijzonderheden zitten. Als er een enorme upswing uitkomt, dan wordt dat vaak getriggerd door een van die variabelen. Dus je doet het in samenspraak, maar de toetsing en het kritisch bevragen van management, “waarom is dit nu je verwachting in de toekomst?” ligt bij het audit team.

Commented [JCd(26)]: UNCERTAINTY information

Zijn er ook voorbeelden van situaties waarin er bijna geen informatie beschikbaar is? Vanuit de markt bijvoorbeeld?

Uit de markt wel.

Maar bijvoorbeeld die level 3 inputs?

Dat kan. Dus dan kom je heel erg uit bij management assessment, “dit is wat wij denken.” Ja, dat gebeurt, natuurlijk.

Is het ook moeilijker om de betrouwbaarheid van fair value waarderingen te garanderen als er bijvoorbeeld in de economie unieke dingen plaatsvinden, zoals een crisis, of een plotselinge stijging in de inflatie?

Uiteraard. Als er zich iets op dit moment al voordoet en we zijn bezig met een fair value bepaling, dan is de eerste vraag die je stelt: in hoeverre hou je daar rekening mee bij het bepalen van je fair value? Hoe zit dat in je model versleuteld? Of is het iets dat jou niet raakt om wat voor reden dan ook? Een algehele economische crisis raakt iedereen. Dus je stelt die vragen wel, maar als het zich op dit moment niet voordoet, er geen indicatie voor is en de klant houdt er ook geen rekening mee dat er in een tien jaar prognose zich iets kan voordoen, zou ik het wel bijzonder vinden als de klant het versleuteld in zijn model, want waar baseert hij dat dan op? Dus dat is lastiger te toetsen. Dan ga je vaak terug naar historie van de klant, en in het geval van een specifieke verstoring ga je kijken: wat zien we nu? Wat is gebruikelijk op welke manier je dat dan versleuteld in je model? Dat is wel heel lastig.

Commented [JCd(27)]: UNCERTAINTY macro-economic shock

Dus een gebrek aan vergelijkingsmateriaal komt dus soms wel voor?

Je probeert het wel. Het grote voordeel van een specialist inschakelen is dat zij al dit soort transacties zien. Zij hebben in ieder geval vergelijkingsmateriaal bij waar ze op dat moment nog meer bij betrokken zijn, zonder dat ze dat één op één in het dossier kunnen stoppen, maar het is wel wat ze zien. Dat is het grote voordeel. Maar transacties kunnen uniek zijn en als het gevolg daarvan het bepalen van fair value ook. En wat ik zelf altijd vind, met name vanuit overnames maar het kan ook vanuit een individueel actief zijn, als er enorme schommeling zit in de fair value, of op het moment dat er een enorme afwijking zit tussen wat ik ervoor betaal en wat ik het waard vind, dat is een indicatie dat er mogelijk optimisme of pessimisme in je model zit. Je kan altijd een lucky buy hebben, goed uitonderhandeld en het is veel meer waard, dat kan. Maar normaal gesproken zou je verwachten dat de verkopende partij diezelfde informatie ook heeft en daarom de prijs wat hoger zou inzetten. Dus dat zijn vaak wel de sanity checks die je aan het eind doet, wat komt er nou onder aan de streep uit mijn overname en begrijp ik dat nu? Is het logisch dat er een dermate hoge post goodwill of badwill uitkomt en dat mijn step up om van een kostprijs naar een fair value te gaan zo groot is? Begrijp ik dat überhaupt wel, conceptueel? Begrijpt de klant het zelf wel? Kan de klant dat ook verklaren? Als dat niet lukt, je hebt een sanity check gedaan en de uitkomsten lijken toch wat onlogisch,

Commented [JCd(28)]: UNCERTAINTY information

Commented [JCd(29)]: UNCERTAINTY measurement

dan is dat vaak het moment dat je nog een keer teruggaat naar de modellen om te kijken waar dat dan door getriggerd wordt en klopt het dan wel?

Commented [JCd(30)]: PROCESS

Hoe kijk je aan tegen de relatie met de klant?

De relatie als in hoe wij gezamenlijk naar fair value kijken?

Dat je bijvoorbeeld hun modellen controleert en daar kunnen dan andere uitkomsten uit voortvloeien dan zij hebben gehad. Wat gebeurt er dan?

Challenges, dan ga je het gesprek aan. Dus op basis van dezelfde informatie zouden wij dit verwachten. Dan kan het management zeggen dat we het verkeerd zien of verkeerd begrepen hebben, dat kan. Het kan ook leiden tot een aanpassing van de berekening. Als het model technisch fout is, kunnen we vrij goed uitleggen dat het in de techniek zit. Dan heeft de klant over het algemeen geen optie, dan passen ze het model gewoon aan.

Commented [JCd(31)]: AUDITEE discussion

Maar als het gaat om assumptions?

Ja, qua assumptions, dan kunnen wij een ander standpunt hebben en dat kan leiden tot een aanpassing van hun assumptions. Daar zit natuurlijk wel de complexiteit.

Commented [JCd(32)]: DIFFICULTY models and assumptions

Heb je ook wel eens meegemaakt dat zij beargumenteren waarom jullie het verkeerd hebben?

Tuurlijk. Uiteindelijk komen zij met een verhaal naar ons toe, met een berekening waar ze achter staan. Ze komen niet met een berekening waarvan ze zeggen: dit is een goede basis qua uitonderhandeling waar we op uit willen komen. Dus op het moment dat wij een materieel ander visie hebben, dan zitten we tegenover elkaar en dan hebben we wel een gesprek ja.

Commented [JCd(33)]: AUDITEE discussion

En die discussies komen uiteindelijk goed?

Dat kan. Het kan ook zijn dat je zegt: het verschil is niet materieel, maar we nemen het op in onze controleverslag. Dus als ze binnen een acceptabele bandbreedte zitten zodat het geen impact heeft op je uiteindelijke verklaring, dan kan de klant ervoor kiezen: dan blijf ik hierbij.

Maar het kan niet zo zijn dat je er gezamenlijk niet uitkomt. Als wij lijnrecht tegenover elkaar zitten en het gaat om grote bedragen...

Materiële misstatements dat kan niet?

Nou ja, tenzij een klant accepteert dat het een andere verklaring tot gevolg heeft. Maar dat wil een klant niet, dus nee, je kunt nooit dat soort open eindjes hebben. En het blijven schattingen en dat maakt het wel complex. Toekomstprognoses die je erin gooit. Je weet één ding zeker, er komt nooit exact uit wat jij in je begroting en in je budget hebt staan.

Er is veel onzekerheid in de schattingen. Assumpties van het management zijn vaak subjectief van aard. Hoe ga je om met deze subjectiviteit? Hoe stel je je op? Want er is natuurlijk best wel wat ruimte voor management bias.

Ik begin altijd te kijken wat het belang van het management zou zijn welke richting ze op zouden gaan. Daar heb je wel vaak wel indicaties in. Zou management nou willen dat de fair value omhoog of omlaag gaat, afhankelijk van waar het bedrijf zich in bevindt en hoe de ontwikkelingen bij het bedrijf zijn en de resultaten op dat moment. Kan dat ervoor zorgen of ze een hogere of een lagere fair value zouden willen hebben? Dus dat is één. Dus vanuit die gedachte ik wel kijken. Ervan uitgaande dat ze een upswing zouden willen hebben van een fair value, dan zal over het algemeen de assumptie wat positiever zijn ingestoken. Als je dat weet, ga je kijken naar wat het bedrijf tot nu toe gepresteerd heeft. Ik noem maar wat, als EBITDA een belangrijke parameter is in het model, wat hebben ze tot nu toe gerealiseerd? Dus dan ga je eigenlijk terugkijken. Wat is de kwaliteit van de schattingen van het management überhaupt geweest? En je probeert zoveel mogelijk aansluiting te zoeken bij andere modellen die de klant al heeft aangeleverd, zodat ze niet specifiek voor dit element een ander budget zouden hanteren het goedgekeurde budget dat ze al hebben. Dat zie je ook nog wel eens in de praktijk. Dat ze dan zeggen: nee, maar dit is specifiek. En dan zie je een afwijking ten opzichte van een budget dat ze eigenlijk gebruiken voor een impairment test of voor de bank. Je gaat een sensitiviteitsanalyse doen. Er kan enig optimisme of bias in zitten maar wat is eigenlijk het effect daarvan als je kijkt naar bepaalde regels, en waar zit dat schattingselement? Dat zit niet op alle parameters maar op een aantal. Wat gebeurt er als je daar nou gaat plussen, wat doet dat eigenlijk met het model? Dus dat doe je. Je gaat terugkijken, sensitiviteitsanalyse doen en je probeert aansluiting te vinden bij andere bronnen.

Commented [JCd(34)]: AUDITEE discussion

Commented [JCd(35)]: DIFFICULTY factors

Commented [JCd(36)]: MANAGEMENT BIAS actions

Commented [JCd(37)]: MANAGEMENT BIAS consistency

Commented [JCd(38)]: MANAGEMENT BIAS actions

Als management een groei van 20% verwacht maar de markt wereldwijd krimpt, dan heeft management wel wat uit te leggen hoe zij denken een groei te realiseren terwijl de markt aan het krimpen is. De competitors hebben dezelfde ambitie.

Dus je hebt wel voorbeelden waar management biased is?

Ja hoor. En ook, wat we net al hebben gezegd, dat het management inconsistent is in de aannames. Dus dat ze bij de een dit zegt en bij de ander daar niet mee rekent. Dat zijn de makkelijkste discussies. Daarvan kan het management natuurlijk nooit zeggen dat het logisch is dat je twee verschillende omzet definities hebt, dat gaat niet.

Commented [JCd(39): MANAGEMENT BIAS consistency

Zijn er bepaalde posten waar het extra belangrijk is dat je oplet voor management bias, met betrekking tot fair value?

Dat is denk ik klantspecifiek, dat kan. Ik kan me voorstellen dat in het geval van een overname bepaalde posten heel interessant zijn, waar je eerder bias zou hebben.

En bijvoorbeeld bij lanceren van nieuwe machines of producten.

Bijvoorbeeld, dan kan het heel interessant zijn dat het een bepaalde waarde gaat presenteren. Sommige klanten sturen heel erg op EBITDA, dus dat is voor afschrijving. Dan is het net wat minder interessant of het nou op je balans of op je P&L staat. Als je afschrijving heel relevant vindt, krijg je een heel andere discussie. Wat is de looptijd waarop ik het kan afschrijven? Als zij daar niet op sturen dan is het veel minder relevant. Maar natuurlijk zijn er posten waar het management... Als het management zegt: dit moet een succes worden, dit is voor ons heel belangrijk, we hebben hier ontzettend veel... we hebben ons zo gepositioneerd, dit wordt het belangrijkste, dan is de kans dat ze dat in een waardering terug laten komen wel logisch.

Commented [JCd(40): MANAGEMENT BIAS items

Terugkomend op de relatie met de specialist. Wat is ongeveer de frequentie dat je beroep op ze doet?

Per klant of per jaar?

Bijvoorbeeld bij een klant met fair value waarderingen, hoe vaak schakel je dan door naar een specialist?

Per post waarvan ik denk dat het complex is, schakelen we door. Dus bijvoorbeeld bij een klant in [plaats] die ik samen met [collega] doe, daar schakelen we ze in voor de derivaten en bij de overname. Daar schakelen we ze op twee onderwerpen in en dat is allebei vrij uitgebreid. En een klant waar ik vanochtend zat, daar schakelen we ze alleen in voor de overname, ook vrij uitgebreid dus hun involvement is dan echt weken. En bij klanten waar je een relatief eenvoudige post zou hebben, daar kun je het wat meer op afstand doen. Maar ik weet gewoon wat ik kan en ik weet gewoon wat ik niet kan, en een specialist is niet voor niks een specialist.

Commented [JCd(41)]: SPECIALIST engagement

Commented [JCd(42)]: KNOWLEDGE AND EXPERTISE help

Dus, dat zei je eerder al, het is een continue wisselwerking tussen jou en de specialist? Begeleid je ze en instueer je ze? Of zeg je: ik snap het niet, jij hebt de vrijheid.

Nee. We proberen in ieder geval goed af te bakenen wat ze wel en niet doen. Want wat je inderdaad wil voorkomen is dat iets tussen de wal en het schip raakt. Als zij een dag voor het aftekenen een memo sturen met al hun bevindingen, uitkomsten en de waarderingen, en ze vinden de waardering akkoord in hun conclusie, maar ze schrijven in hoofdletters op dat het audit team, zijnde niet de specialisten, nog een aantal van de aannames wel moet challengen, dat dat voor hen een gegeven is en waar ze niks mee hebben gedaan als het gaat om het challengen, dan heb je wel een probleem. Want dan klopt het rekenkundig wel en het model hebben ze goed toegepast, maar belangrijke parameters in die berekening daar doen ze eigenlijk niks mee. Dus je probeert van tevoren heel goed af te bakenen: wat, wanneer en hoe? En met name op het moment dat de klant een specialist inschakelt om ze te ondersteunen bij het bepalen en wij schakelen eigenlijk een counterpart in, ook een specialist, dan zouden we ook tijdige respons willen hebben om te waarborgen dat als er verschillen uitkomen, dat we dan nog terug kunnen gaan en het gesprek aan kunnen gaan, maar ook eventuele vervolgstappen kunnen definiëren. Dus het is een continu proces.

Commented [JCd(43)]: SPECIALIST interaction

Commented [JCd(44)]: AUDITEE specialist

Commented [JCd(45)]: SPECIALIST interaction

Dus als zij iets aanleveren dan speel je dat niet automatisch door naar de klant?

Nee. Ik wil het eerst zelf begrijpen. Niet zozeer de techniek die zij helemaal in detail hebben toegepast, maar als zij opschrijven dat ze iets niet reasonable vinden of niet juist, dan wil ik het wel begrijpen. En al dan niet treden we gezamenlijk op naar de klant. Als het een heel

technische discussie is tussen de ene specialist en de andere, dan ben ik niet altijd in detail involved omdat het dan echt op specialistenniveau gaat. Maar ik wil wel begrijpen waarom we iets goed of fout vinden.

Commented [JCd(46)]: SPECIALIST understand

Ok. Hebben de mensen in het audit team die zich bezighouden met fair value waarderingen volgens u voldoende ervaring en kennis op dit gebied?

Over het algemeen wel.

Komt het wel eens voor dat er iemand mee bezig is die er niet genoeg kennis en ervaring voor bezit?

Ja. Dan grijp je in. Ik zorg ervoor dat ik bij dit soort dingen nooit achteraf of helemaal aan het eind erachter kom dat iemand iets niet begrepen heeft.

Dan krijgt bijvoorbeeld iemand in het team een post toebedeeld die op fair value gebaseerd is. Ga je dan eerst achterhalen wat zijn kennis en ervaring op dit gebied is?

Ik ken mijn teamleden redelijk goed. We gaan gewoon eerst samen zitten. Zeker als het iemand is die voor het eerst deze post bij deze klant gaat controleren. Dan gaan we van tevoren samen zitten.

Commented [JCd(47)]: KNOWLEDGE AND EXPERTISE insufficient

Wordt je ook op andere manieren klaargestoomd voor dit ingewikkelde werk? Het waarderen tegen fair value is namelijk best veelzijdig.

Niet specifiek. Het is niet dat we binnen KPMG specifiek zeggen: hier, even over de fair value, en we gaan nu het volgende doen en we gaan jullie daar een aparte training voor aanbieden. Wat we ze duidelijk maken is dat het complex kan zijn, waar de complexiteit in zit. Ik denk dat dat wel heel breed wordt uitgelegd. Het wordt ook gepromoot om specialisten in te schakelen. Ik denk ook dat we overigens op alle gebieden steeds meer met specialisme te maken krijgen, naarmate het complexer wordt, belastingen kunnen ook heel complex zijn, dus dan heb je meer onderwerpen. Ik denk dat we meer met specialisten moeten gaan werken, zodat je ook een efficiënte controle hebt. Maar het is niet zo dat teams er speciaal voor worden klaargestoomd.

Commented [JCd(48)]: KNOWLEDGE AND EXPERTISE training

Ben je er zelf ook een beetje ingerold?

Ja. Op het moment dat je het tegenkomt bij een klant, niet elke klant heeft het, dan heb je denk ik een wisselwerking dat degene die moet controleren ook zo eerlijk moet zijn door aan te geven: ik kan het niet, of ik weet het niet, of kun je me hier meer over uitleggen? En diegene die hem of haar begeleidt heeft natuurlijk dezelfde verantwoordelijkheid. Maar dat is niet eens fair value specifiek. Zo controleer je binnen het team.

Commented [JCd(49): KNOWLEDGE AND EXPERTISE help

Hoeveel waarde hecht je aan het belang van ervaring bij fair value waarderingen?

Ja goed, aan de andere kant zul je altijd een keer moeten beginnen. Eens is de eerste keer en dan doe je het samen, dan treed je samen op. Het kan niet zo zijn dat je een complex iets bij iemand weglegt die het nog nooit gedaan heeft en zegt: succes. Dan kijk je meer mee en ga je gezamenlijk optrekken en leg je natuurlijk een aantal dingen bij deze persoon weg, maar je kijkt ook mee.

Commented [JCd(50): KNOWLEDGE AND EXPERTISE experience

Kijk je nog meer mee dan wanneer je iets nieuws uitlegt over een andere post die niet tegen fair value gewaardeerd is?

Ik maak daar niet per se het onderscheid. Mij gaat het om de complexiteit. Stel bij de fair value van een pand moet een reële waarde worden bepaald en er wordt een taxateur ingeschakeld door de klant, of misschien wel door ons, dat vind ik een andere orde dan een of ander technisch model van een complex financieel derivaat.

Commented [JCd(51): KNOWLEDGE AND EXPERTISE compare

Ok. Als je kijkt naar de professioneel kritische houding. Is die ook groter? Stel je je er op een andere manier op in wanneer je fair value gaat auditen?

Wel omdat daar meer aannames in zitten van management. Er is meer ruimte voor verschil van inzicht. Als je het negatief zou willen uitleggen: er is meer ruimte om zaken negatief te beïnvloeden. En daarmee is het professioneel kritische extra belangrijk. Dat begint al door aan de voorkant na te denken: waar zit die ruimte? Welke tendens verwacht ik? Dus ik denk dat je daar sneller extra professioneel kritisch moet zijn.

Commented [JCd(52): SCEPTICISM importance

Kun je die ook waarnemen, die extra professioneel kritische houding bij teamleden?

Nou, kun je die waarnemen? Wat ik probeer mee te geven...

Of geef je wat mee inderdaad?

Ja, dat wel. We hebben binnen KPMG zo'n professioneel kritisch judgment framework. Dat zijn een aantal stappen die wij zouden moeten ondernemen in je werk, maar zeker ook dingen die je in je achterhoofd moet houden. Het gaat bijvoorbeeld niet alleen maar om het toetsen van aannames van de klant maar ook proberen om andere informatie erbij te betrekken om te kijken of er andere visies zijn, zelfstandige standpunten innemen, die stappen worden beschreven. En met name bij dit soort wat complexere dingen, die we bij onszelf houden, dus niet waar we een specialist voor inschakelen maar bij de elementen die we zelf oppakken, dan leg je dat ook voor. Dan zeg je: eigenlijk moet je deze stappen ondernemen, want vaak doen we heel veel, we bespreken het wel en we challengen het wel, maar dan blijkt het niet uit het dossier. Dan stoppen we de einduitslag van de fair value assessment in ons dossier, mooi rapportje erbij, daar staat nog een conclusie op dat het klopt, maar daar aan voorafgaand zijn misschien wel zestien andere berekeningen geweest met hele andere uitkomsten. Maar dat stoppen we niet in ons dossier omdat je wil voorkomen dat je zestien versies hebt, wat is dan de juiste? Maar daardoor mis je een beetje het traject van wat je allemaal al gedaan hebt. Dus die challenge je met name om het goed te documenteren. Ik denk dat ze in de regel wel goed begrijpen waar ze op moeten challengen. Meestal heb je het er even over en ze weten dan al: hier moeten we naar kijken, maar dan documenteren we het ook niet goed. Dus dan blijkt nergens uit de file wat je allemaal gedaan hebt.

Commented [JCd(53)]: SCEPTICISM extra

Als je het auditen van fair value vergelijkt met het auditen van normale posten, wat zijn dan de belangrijkste verschillen?

Ik denk de complexiteit die eraan ten grondslag ligt als het gaat om het berekenen van de fair value, ervan uitgaande dat je dat op basis van de modellen moet doen. Dat is denk ik lastig. En je bent sneller geneigd om een specialist in te schakelen waardoor je eigenlijk een gedeelte bij je gezichtsveld hebt. Dus dan is het afbakenen van "wie doet wat" een belangrijke. En als je het over complexe financiële instrumenten hebt, dan heb je de boekhoudkundige verwerking, dus de accounting daarvan, is ook wel een aandachtspunt. Dat vind ik over het algemeen complexer dan bij andere posten.

De audit van fair value is een veelzijdige bezigheid. Daarnaast moet er veel informatie verwerkt worden: aannames van management, regelgeving, vele waarderingsmodellen. Daarnaast zijn er factoren als onzekerheid en complexiteit die de audit van fair value lastiger maken. Vindt u dat het binnen de mogelijkheden van de auditor ligt om een kwalitatief goede audit te verrichten?

Ja, zolang je maar weet wat je weet en weet wat je niet weet. Dus zorg dat je het bij de juiste mensen belegt, dan kan het zeker. Ik denk dat het gevaar erin zit dat mensen denken dat ze het zelf wel kunnen en dat het niet zo complex kan zijn. Dus ik denk dat als je herkent dat het complex is, kun je zeker een goedkeurende verklaring afgeven, maar dan moet je wel je specialist inschakelen.

Commented [JCd(54): COGNITIVE ability

Laatste vraag: wat zouden verbeteringen kunnen zijn om de kwaliteit van de audit van fair value te verhogen?

Het grote risico bij fair value is dat je nu iets moet waarderen met iets waar toekomstige informatie aan ten grondslag ligt. Dus je weet eigenlijk één ding zeker: de fair value die ik dit jaar bepaal, als ik die volgend jaar weer ga bepalen wordt ie anders. Ik denk als we dat accepteren en gedegen doen dan denk ik dat we de goede dingen doen. Maar dat maakt het complex. Begrijpen we jaar in jaar uit waarom fair value muteert. En zijn we in staat om dat goed te analyseren en ook mee te nemen met de controle van het jaar daarop. Dus stel je voor dat ik een pand die op fair value wordt gewaardeerd vorig jaar op een miljoen heb gewaardeerd, en het jaar daarop is ie op acht ton gewaardeerd op basis van een taxatierapport. Waar kunnen we nou in verbeteren? Snappen we waarom het nou acht ton is? En wat betekent dat dan? Hebben we dan wel genoeg rekening gehouden met de factoren die zich in één jaar hebben voorgedaan? En is die acht ton dan wel die acht ton?

Commented [JCd(55): UNCERTAINTY measurement

Het te makkelijk overgenomen naar een volgend jaar?

Nou ja, je loopt het risico dat je eigenlijk zegt: dit is de fair value nu, volgend jaar maak ik een nieuwe berekening en de fair value is anders, ok weet je wat, het model klopte nog steeds en die input snappen we wel een beetje dus de uitkomst is de uitkomst. Maar snappen we de uitkomst wel? Ik heb een klant gehad waarbij we hele discussies hadden over alle factoren die

we meenamen, en een voor een waren we het over alle op zich zelf staande elementen eens, inclusief het budget, inclusief het model, inclusief de interestvoet die je moet hanteren, we waren het over alles eens. En dan stop je iets in het model en daar komt dan iets uit en die uitkomst begreep ik dan niet. Die was raar. De klant zegt: die moet wel kloppen want alle elementjes kloppen.

Maar het was niet logisch?

Nee, het was totaal niet logisch. Maar dan ga je kijken naar alle elementjes. Bij alle elementjes accepteer je een kleine... weet je wel binnen de acceptabele range. Bij elke zat de range wel aan de bovenkant. Dus per element accepteer je dat die een beetje aan de bovengrens zit van wat we acceptabel vinden. Maar ja, hoe rekent zo'n model dat dan door, daar kom je pas achter als er een keer een getal in gooit. Met al die dingen daarboven, alles heeft hetzelfde effect. Dat had een enorm opstuwend effect in je reële waardebeoordeling. Maar de uitkomst vond ik echt veel te hoog, op basis van wat je zou verwachten. De klant zei: dat mag je nou niet meer vinden. Dan raken ze natuurlijk geïrriteerd want we hadden alles aan de voorkant afgebakend en dat vonden we goed. Maar er zit dan toch teveel optimisme. Je verspreidt het optimisme over alle dingetjes waar je het in kwijt kan.

Commented [JCd(56)]: UNCERTAINTY measurement

Dus de verbetering is dan om marges te verkleinen?

De verbetering is denk ik dat je technisch moet begrijpen hoe het allemaal werkt, maar je moet ook de uitkomst kunnen begrijpen. Dus je moet proberen te voorkomen dat je zegt: ik snap het model en ik snap de input. Maar dat je de output dan niet begrijpt. Je moet zorgen dat je de output ook altijd begrijpt. En het is niet zo dat dat altijd de waarheid moet zijn. Ik denk dat je daar een laatste verantwoordelijkheid hebt. Wees kritisch op wat er dan uitkomt. Is het eigenlijk wel logisch. Ik denk dat je te vaak nu ziet dat mensen zeggen: het moet wel kloppen want alle op zichzelf staande elementjes vonden we ook al goed. Dat als zo'n taxateur in een keer met een hele andere waarde komt, dat jij dan denkt: dat is wel bijzonder want ik hoor dat de huizenmarkt aantrekt en de gebouwenmarkt ook. En er zit een fantastisch verhaal bij en het is een taxateur. Moeten we dat dan voor waar aannemen? Vaak zijn we dan geneigd om blij te zijn dat we een extern onafhankelijke partij het heeft gedaan. Dat weet je niet, dus je moet kritisch blijven tot het eind, tot en met de uitkomst aan toe. En je moet wel durven accepteren dat er altijd een onzekerheid in zit. Het is reële waarde gebaseerd op een aantal onzekerheden.

Commented [JCd(57)]: COGNITIVE improve

En consistentie is natuurlijk wel fijn. Bepaalde consistente gedragslijnen en keuzes van het management, dan weet je in ieder geval dat je de bias eruit haalt. Doordat ze elk jaar jaar in jaar uit een soort van dezelfde parameters hanteren. Dan voorkom je in ieder geval dat management elke keer aan een knop zit te draaien waarvan ze elke keer een nieuw verhaal moeten verzinnen. Maar het is complex, ik denk zoveel mogelijk... maar daar gaan we in de controle sowieso naartoe denk ik, het is gewoon allemaal specialisme, het wordt ook niet makkelijker, dus accepteer het dat je sommige dingen in detail niet meer zelf kan, maar dat je daar bewust mensen voor opgeleid hebt.

Commented [JCd(58): MANAGEMENT BIAS consistency

Commented [JCd(59): DIFFICULTY increasing

Ok dat was 'm, hartstikke bedankt.

Graag gedaan.