CBV Chartered Business Valuators Institute

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VALUATION EXPERTS IN FINANCIAL REPORTING

The role of valuation experts and other key individuals in the financial reporting ecosystem

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This publication is a collaboration between the Canadian Public Accountability Board (CPAB) and the Chartered Business Valuators Institute (CBV Institute). It is intended to provide clarity around the role of valuation experts, auditors and management, in the context of preparing and reviewing valuations used in financial reporting.

CPAB is Canada's independent, public company audit regulator. Charged with overseeing audits performed by registered public accounting firms, CPAB contributes to public confidence in the integrity of financial reporting and is committed to protecting Canada's investing public.

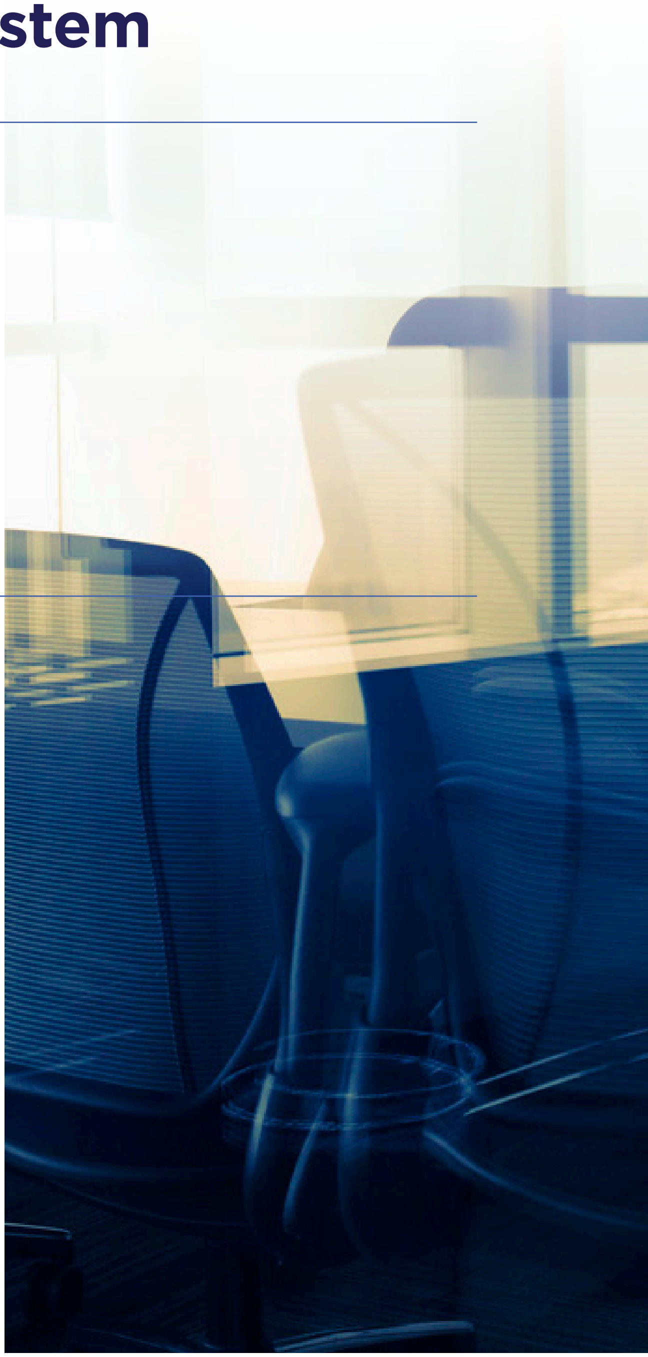
CBV Institute is the professional organization that oversees the training and certification of business valuation professionals in Canada. Dedicated to serving the public interest, CBV Institute sets the standards for business valuation practice and promotes the highest level of professionalism and ethical conduct among its members.

The role of valuation experts in the financial reporting ecosystem

DISCLAIMER

The preparation of the entity's financial statements in accordance with the applicable financial reporting framework is management's responsibility. However, management may choose to engage an external valuation expert to assist them. Management is also responsible for ensuring the auditor and, where applicable, their valuation expert, are provided with all relevant information.

The examples provided in this document are intended to be illustrative in nature, and predicated on the assumption that the underlying assumptions, estimates and related financial statement balances or transactions are material to the financial statements.



Valuation experts[1] play an important role in the financial reporting process. They are commonly engaged by both the management of an audited entity ("management") and auditors to assist with valuations that support certain amounts recognized within financial statements. Valuations for financial reporting commonly arise in accounting for transactions such as business combinations and asset acquisitions, impairment of assets and other fair value measurements.

Engaging a valuation expert for business and asset assessments can be highly beneficial, given the level of technical expertise and professional judgment required and the complexity of methodologies and models, which is magnified by the volatile economic landscape.[2]

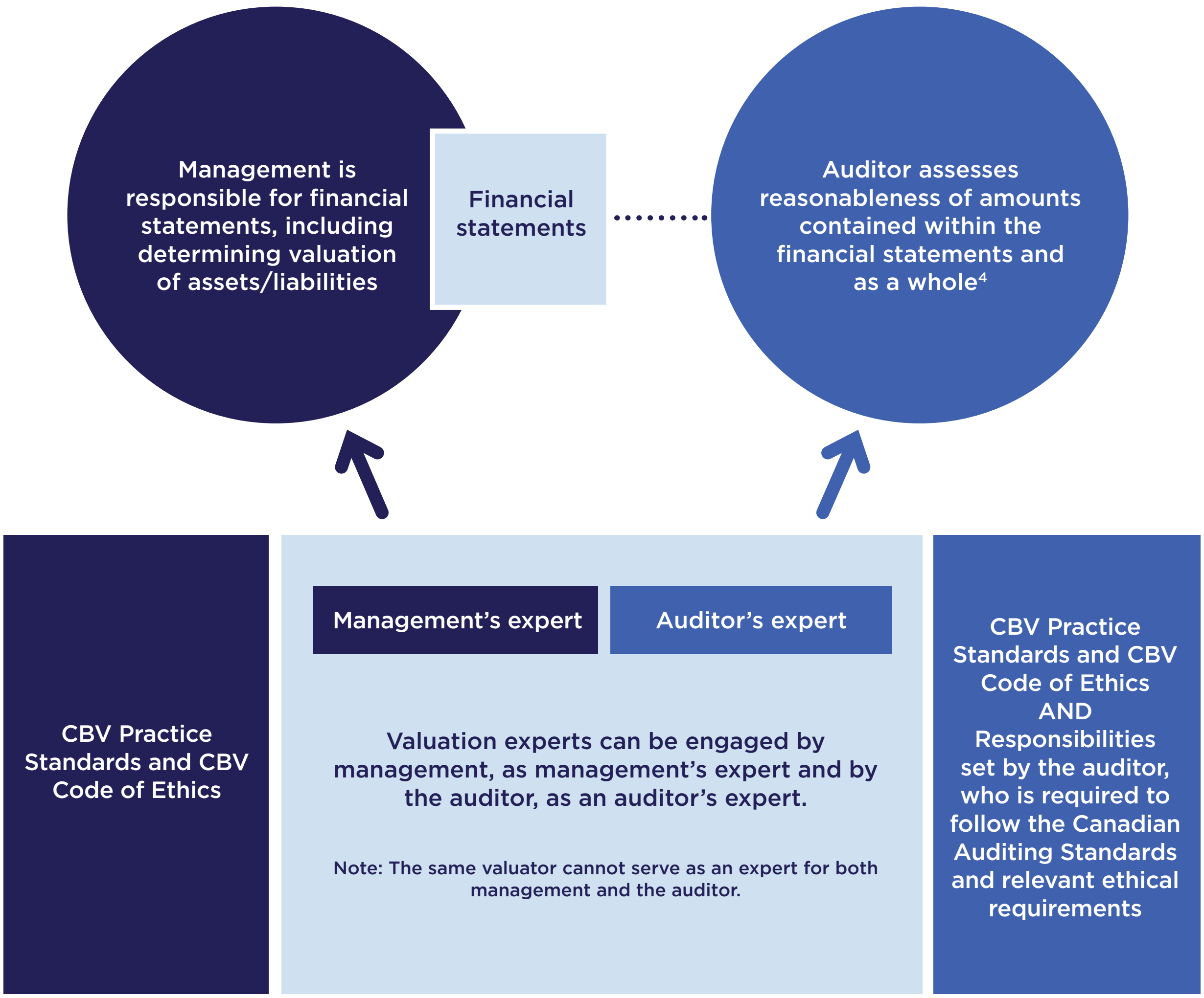
This publication provides information for those involved in preparing, reviewing and auditing valuations used in financial reporting. It also offers insights into applicable terminology used within the Canadian Auditing Standards (CAS)[3] and CBV Institute's Practice Standards and courses. This publication also highlights good practices observed and provides illustrative scenarios to commonly encountered issues. Readers may find that the adoption of these good practices may lead to a smoother financial reporting and audit process.

1 For the purposes of this publication, a valuation expert is a Chartered Business Valuator ("CBV"). A CBV's expertise in business and intangible asset valuation is widely recognized in Canada and globally.

2 The economic environment that reporting issuers face changes continually, with many factors affecting economic conditions including, but not limited to supply chain challenges; conflicts; escalating energy supply shortages and costs; labour shortages, market volatility, interest rates, changes in monetary and fiscal policies, and other responses from central banks and other government authorities. (International Organization of Securities Commissions. Recommendations on Accounting for Goodwill (December 2023), p 4. Retrieved from https://www.iosco.org/library/pubdocs/pdf/IOSCOPD753.pdf).

3 Auditing standards relevant to valuation include: CAS 500, Audit Evidence, CAS 540, Auditing Accounting Estimates and Related Disclosures and CAS 620, Using the Work of an Auditor's Expert.

There are many different individuals that can be involved in valuations for financial reporting. The following diagram depicts the role of valuation experts in the financial reporting eco-system.



4 In accordance with CAS 200, paragraph 11(a), the auditor expresses an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. As a basis for the auditor's opinion, the auditor is required to obtain reasonable assurance about whether the financial statements as whole are free from material misstatement whether due to fraud or error. CAS 620, paragraph 3 clarifies that the auditor has sole responsibility for the audit opinion expressed, and that responsibility is not reduced by the auditor's use of an auditor's expert.

Comparing the roles of valuation experts

The following chart outlines some key differences in the role of valuation experts in the financial reporting process.

Valuation expert as management's expert

ROLE:
Engaged by management, often as an independent expert to opine on the values of assets/liabilities, or an equity instrument.

When engaged to provide a value conclusion to management, these valuation experts typically prepare a valuation report that appropriately describes and supports how the expert arrived at the valuation conclusion. The type of valuation report and scope is based on discussions with management and is prepared under CBV Institute's Practice Standards.[5] These standards provide the minimum expectations for scope of work, documentation and reporting.

Valuation expert as auditors' expert

ROLE:
Engaged by the auditors to assist with assessing the reasonability of management's valuation.

Even though management may have engaged an external valuation expert, auditors must treat these experts as extensions of management. To obtain sufficient appropriate audit evidence over the work of management or management's valuation expert, auditors may determine that it is necessary to engage a valuation expert of their own to assist with performing procedures that will support the audit opinion.

5 Namely, Practice Standards Nos. 110, 120 and 130, and Appendix B to Practice Standard No. 110. CBV Institute also permits the use of International Valuation Standards (IVS) as issued by the International Valuation Standards Council (IVSC).

Valuation experts engaged by management

Determining the appropriate engagement

Management determines the scope of the engagement and type of valuation services they require when engaging a valuation expert. Different types of valuation reports exist to offer different levels (see below) of review, analysis and corroboration (referred to as "scope of work") by the valuation expert. The type of report that is most appropriate can be influenced by several factors, such as:

- Significance of the estimate to the entity's financial statements.
- Requirements set by external parties.
- Management's lack of internal valuation expertise.
- Magnitude of the account balances, along with the complexity and subjectivity of valuation estimate.
- Degree of estimation uncertainty[6] in the accounting estimate.

As the weight of these factors increases, this may lead management to request a more in-depth scope of work performed by qualified valuation experts.

Understanding valuation reports

There are three types of valuation reports: Calculation, Estimate and Comprehensive.[7] Individually, these reports provide different levels of review, analysis and corroboration,[8] with a Calculation report offering the lowest, and a Comprehensive report, the highest. Regardless of the report chosen for the valuation, the scope of work can vary.

When preparing a valuation for financial reporting purposes[9] (e.g. accounting estimates used for business combinations, asset acquisitions and impairment testing), management should discuss the scope of work with the valuation expert and where possible, their auditor. If the accounting estimate has a higher degree of estimation uncertainty, it would be prudent for management to request a higher scope of work. Furthermore, the auditor may have determined that the accounting estimate has a significant risk of material misstatement, in which case the limited scope of work of a Calculation Valuation Report[10] would generally not provide sufficient audit evidence. **As such, CBV Institute recommends that the valuation report be at least at the Estimate-level if the report is to be used for financial reporting purposes.** Regardless of level, management must ensure that the degree of analysis and work adequately supports the key inputs and assumptions impacting the accounting estimate.

6 Estimation uncertainty is the inherent lack of precision in an accounting estimate. Factors that impact the degree of estimation uncertainty in an accounting estimate include, but are not limited to complexity, subjectivity, availability and reliability of data.
7 CBV Institute Practice Standard No. 110.
8 Note that corroboration is not defined under CBV standards, nor does it necessarily align with the terminology used under CAS standards.
9 CBV Institute Practice Bulletin No. 3 also states that the client's need for assurance should be considered and that the report must always be suitable for its purpose.
10 Although technically a viable option, a Calculation report may be insufficient (and lead to increased audit fees and work effort) as it involves the lowest level of review and corroboration.

Good practices observed for management and their valuation expert

As previously noted, a valuation expert can help to address the inherent complexities that are involved in preparing an accounting estimate. Under CBV Practice Standards, a valuation report used for financial reporting purposes should include narrative explanations, detailed calculations and schedules to help the readers (i.e. auditor and management) understand how the valuation expert arrived at the conclusions expressed in the report. The valuation report should clearly explain how the valuation expert reached their conclusion. It should include key inputs, assumptions (and their basis), key areas of professional judgment, and the chosen valuation method along with the reasons for selecting it. This information is relevant because:

- Management must demonstrate an understanding of the valuation performed, and the work performed by the expert in preparation for the audit.
- Management will use this information to demonstrate they have addressed the level of estimation uncertainty contained within estimates in the financial statements.[11]
- It will assist the auditor in evaluating the completeness and accuracy of information used to support the valuation, as well as the relevance and reliability of any information provided by a third-party source.

To assist management with the subsequent audit process, their valuation expert should:

- Establish key timelines and maintain open communication with management, including whether to expand the valuation mandate past the valuation date to account for any relevant subsequent events.
- Follow the relevant CBV standards for scope of work, reporting and documentation.
- Identify the source of key data inputs to ensure they are supported.
- Ensure business level valuations consider relevant information such as analyst or industry reports, public filings, long-term industry outlooks, projected margins, and industry growth rates in understanding and validating projections.
- Ensure assumptions used in the valuation are consistent with management's assumptions used elsewhere in the preparation of financial statements, if applicable.
- Hold a meeting with management to walk through the contents of the valuation report and analysis.

Significant inputs and assumptions in determining the fair value of assets or liabilities acquired could include:

- Market demand and competition.
- Relevant industry or market transactions.
- Legal considerations.
- Income generation or cost savings.
- Expected economic life.
- Customer attrition rates.
- Contract renewal rates.
- Obsolescence rates.
- Tax benefits associated with an asset.
- Royalty rates.
- Contributory asset charges.
- Growth and terminal growth rates.
- Discount rates, capitalization rates.
- Costs to replace or reproduce.

11 A detailed valuation report can help management demonstrate to the auditor that particular elements of the valuation with significant estimation uncertainty have been adequately addressed.

Valuation experts engaged as an auditor's expert

Determining the engagement

Under the Canadian Auditing Standards, auditors express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.[12] Auditors should critically assess whether they need to use the work of an auditor's valuation expert to obtain sufficient appropriate audit evidence to support that opinion. Auditors should also clearly communicate the roles and responsibilities for all parties, and any relevant information that is needed for the audit, including:

- The engagement's purpose, including whether their work will directly impact a financial statement line item, such as the valuation of a private company investment, or serve a corroborative role, such as assessing whether an asset is impaired.
- The materiality for the audit, and any relevant considerations that may impact the risk of material misstatement.

This information may help the auditor's valuation expert adequately inform the auditor of the appropriate scope of work and sensitivity analyses.

Good practices observed for auditors and valuation experts

Auditors are required to evaluate the valuation expert's findings in accordance with CAS 620, *Using the Work of an Auditor's Expert*. This includes evaluating the competence, capabilities and objectivity of the auditor's valuation expert and evaluating the adequacy of the auditor's valuation expert's work.

The following good practices have been observed by CPAB:

- Clearly documenting the requirements of CAS 620, such as documenting the skills, experience and expertise of both the auditor's valuation expert and the engagement team members who will be directly involved in reviewing the work of management and/or management's valuation expert.
- Documenting the scope of work and responsibilities of both the auditor and auditor's valuation expert. This includes consideration of engagement expectations and logistical factors (i.e. timing and deliverables). Being clear about the delineation of responsibilities between the audit team and the auditor's valuation expert is important so that procedures are not overlooked.
- Ensuring that all relevant information is provided to the auditor's valuation expert on a timely basis and that this information is captured in the auditor's valuation expert's analysis.
- Assessing and documenting how management understood and addressed the level of estimation uncertainty.[13]
- Assessing the adequacy of the auditor's valuation expert's work for the auditor's purposes.[14] For example, the auditor and auditor's valuation expert could assess the reasonableness of assumptions and methods used by performing a stand-back assessment that considers whether any information obtained during the audit affect the inputs and assumptions used in the valuation.
- Evaluating whether there appeared to be any indication of management bias in the valuation.[15] For example, the audit team and auditor's valuation expert should consider whether specific valuation models or inputs were conservative or optimistic and compare these to other audit evidence gathered during the audit. This evaluation helps determine whether additional audit procedures are necessary to address potential management bias.

Thematically, CPAB has observed higher quality audit evidence when the auditors engage in early, timely and ongoing communication with the auditor's valuation expert.

12 CAS 200, paragraph 3(a).
13 Refer to CPAB's 2021 publication on Auditing Accounting Estimates.
14 CAS 620, paragraph 12.
15 CAS 540, paragraph 32.

Illustrative scenarios

The following scenarios are examples of valuation issues that can arise. This section is intended to outline the balance of responsibilities, as well as potential solutions. While specific issues and responsibilities have been highlighted in each example, we believe all scenarios should be reviewed by all parties in the financial reporting ecosystem (i.e. management, valuation experts and auditors).

The scenarios presented are representative of observations and insights from CPAB's inspections. Facts have been modified or excluded to safeguard the identities of all parties involved.

01

Scenario one

Consideration of 'other available information'

Issue: In preparing the accounting for a business combination, management's valuation expert is provided with cash flow forecasts by management. The forecasts appear to be optimistic and inconsistent (i.e. contradictory) with other externally available information, such as market participant expectations and/or industry outlooks.

Management's valuation expert responsibilities

Cash flow forecasts are a key valuation input. Valuation experts have an obligation to consider key valuation inputs in deriving the overall valuation conclusion. These key valuation inputs require an appropriate level of analysis, support and corroboration.

The CBV Code of Ethics requires that CBVs must not be associated with false or misleading statements. Valuation standards do not explicitly require CBVs to actively seek out contradictory information, however, if contradictory information comes to the valuation expert's attention over the course of the engagement, it cannot be ignored.

Auditor responsibilities

CAS 500, *Audit Evidence*, requires that when information used as audit evidence has been prepared using a management's expert, the auditor shall, amongst other requirements, understand and evaluate the appropriateness of that expert's work.[16] This may include evaluating the relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence.[17]

Under CAS 540, *Auditing Accounting Estimates and Related Disclosures*, the auditor is required to design and perform audit procedures in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.[18]

While the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence, obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources both inside and outside the entity.[19]

In practice, contradictory evidence may be found through procedures performed over other accounts, and when considering information contained in analyst/industry reports, management discussion and analysis (MD&A), press releases or other public documents.

Potential solution

Management's valuation expert should review relevant internal and external sources and discuss key inputs with management to assess the reliability and credibility of the forecasts.

Valuation experts may assist management by flagging potentially contradictory information. For example, the valuation expert should work with management to ensure the forecasted cash flows, where applicable, are consistent with other internal information, external communications, investor presentations, and related relevant public documents.

If any contradictory evidence is known, either by management or the valuation expert, it should be considered and addressed when executing the valuation. This approach is consistent with the requirements of CAS 540, which requires external auditors to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.

This may result in management revising or updating the cash flow forecasts or robustly documenting the rationale for why relevant components of the cash flows are different.

16 CAS 500, paragraph 8.
17 CAS 500, paragraphs 8 and A59.
18 CAS 540, paragraph 18.
19 CAS 540, paragraph A82.

02

Scenario two

Using evidence up to the 'audit report date'

Issue: An entity has a year-end of June 30. On July 31, management engaged a valuation expert, who issued a final valuation report relating to the fair value of an acquired asset as at June 30. On August 15, there is a divestiture of 50% of that same asset that implies a significantly lower valuation than what is indicated in the valuation report and recorded in the financial statements. The audit report date is September 5.

The transaction on August 15 was not considered or addressed in the valuation report nor in management's analysis, raising doubt over the reliability of management's overall accounting estimate.

Management's valuation expert responsibilities

The valuation is at a point in time, June 30, reflecting information that was known and knowable at the valuation date.

In general, the valuation expert is not responsible for information that becomes available after the valuation date, and their involvement generally ends once the final valuation report is issued on July 31.

Auditor responsibilities

CAS 560, *Subsequent Events*, requires the auditor to consider the effects of events and transactions of which the auditor becomes aware and which have occurred up to the date of the auditor's report of September 5.

This would include contradictory evidence identified after the valuation date of June 30 but before the auditor's report date of September 5. Such information should be assessed as to whether it was indicative of a condition that existed at the valuation date or not.

Potential solution

Management and the valuation expert should discuss and consider the timing and scope of the valuation engagement. This may include a decision to expand the valuation expert's mandate past the valuation date of June 30 to take into account any relevant subsequent events (i.e. to consider relevant information up to the audit report date of September 5), if appropriate and warranted.

In practice, management would need to identify and inform the valuation expert of relevant events and conditions after the valuation date (June 30) and up to the audit report date (September 5). The valuation expert would then consider whether the new information was known or knowable at the valuation date, requiring revisions to the valuation.

Management could also engage the valuation expert again at a date closer to the audit report date (September 5) to obtain their assistance in assessing the impact of subsequent events that may impact management's accounting estimate.

03

Scenario three

Appropriate level of involvement from valuation experts

Issue: The auditor requests that their valuation expert perform a limited set of procedures to support their audit of an accounting estimate. The auditor engages the expert, only to assess the adequacy of a discount rate used in the valuation of an equity instrument, which was valued using a discounted cash flow methodology. The auditor will assess the remaining aspects of the accounting estimate (e.g. valuation methodology, sensitivity analysis, etc.)

Auditor's valuation expert responsibilities

The auditor's valuation expert performs only the tasks explicitly requested by the auditor, meaning their scope of work is limited to the provided information and instructions.

Auditor responsibilities

The auditor must determine the nature, scope, and objectives of the expert's work for the auditor's purposes.[20] In practice, CPAB has observed that to meet the requirements of CAS 620, auditor expert memorandums typically outline the scope of work in detail and any associated limitations.[21]

Why is this an issue?

When a valuation expert assesses the reasonability and appropriateness of the discount rate, they must also consider the underlying cash flow assumptions. This is because the discount rate is intended to reflect the risk of the underlying cash flows (i.e. they are highly interrelated). Evaluating a discount rate in isolation may lead to an incomplete assessment and raises concerns about whether sufficient appropriate audit evidence has been obtained to support the accounting estimate.

CPAB has also observed instances where auditors have chosen to evaluate portions of the valuation themselves, rather than involving a valuation expert. In these instances, auditors sometimes fail to identify issues within the valuation model or are unable to conduct appropriate sensitivity analyses due to their lack of technical valuation expertise.

Potential solutions

Proper alignment between the auditors and their expert will help to ensure sufficient and appropriate audit evidence is obtained. Specifically:

- Auditors should carefully assess whether they possess the necessary expertise to appropriately evaluate and challenge the valuation inputs and conclusions.[22]
- Valuation experts and auditors should work closely together to ensure that neither party is working in isolation. For example, auditors should inform the valuation expert of the supportability of the underlying cash flows such that the valuation expert can make a complete assessment of the discount rate.
- Valuation experts should ensure they understand the purpose and scope of the engagement and, in limited circumstances, advise the auditor of any important considerations when their scope of work has been isolated to select components (i.e. solely assess the discount rate).

20 In practice, CPAB has observed that auditors typically assess the completeness and accuracy of underlying inputs, including the relevance and reliability of any externally used sources of information in the accounting estimate, while the auditor's expert assesses the methodology, mathematical accuracy, and valuation-related inputs while also considering the underlying inputs reviewed by the auditor.

21 CAS 620, paragraph 11.

22 CAS 620, paragraph 7 requires that an if expertise in a field other than accounting or auditing is necessary, to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert.

04

Scenario four

Considerations relating to estimation uncertainty

Issue: An entity acquires an intangible asset, as part of a business combination, that is material to the financial statements. Management decides to not use a valuation expert and performs the valuation themselves.

The auditor identifies a significant risk due to the high degree of estimation uncertainty and decides to engage a valuation expert. While conducting their work, the auditor's valuation expert calculates their own point estimate or range (i.e. valuation conclusion) for the intangible asset and arrives at a materially different estimate from the one prepared by management.

Management does not perform any additional work and adjusts their accounting estimate based on a proposed adjustment from their auditor, which is derived from the work of the auditor's expert.

Management's valuation expert responsibilities

The auditor's valuation expert should raise concerns related to the valuation to the auditor so that they can evaluate the significance and consider the impact on the audit approach. The valuator should also work closely with the auditor to ensure that independence is maintained (for example, the auditor may need to obtain additional analyses from management or have management retain an external valuation expert).

Auditor responsibilities

If the auditor determines that management has not taken the appropriate steps to understand or address estimation uncertainty, the auditor must request that management perform additional procedures. The auditor must also evaluate whether a deficiency in internal control exists.[23]

As the complexity, subjectivity and other inherent risk factors for the accounting estimate increases, it becomes less likely the auditor can develop a point estimate or range without sufficient understanding of how management assessed and addressed the level of estimation uncertainty without compromising independence.

If the auditor determines management's response to the auditor's request does not sufficiently address the level of estimation uncertainty, and they cannot develop a point estimate or range without compromising independence, the auditor must evaluate whether the overall objectives of the CAS can be satisfied.[24]

Why is this an issue?

The auditor did not request management to address the level of estimation uncertainty. Under CAS 540 the auditor is required to ask management to perform additional procedures, such as revising the valuation methodology and conclusion, obtaining additional support over key inputs or engaging an independent valuation expert.

If management adjusts the estimate based on the work of the auditor's expert, the auditor's independence may be compromised as this creates a self-review threat where the auditor is effectively assessing their own expert's analysis, potentially undermining professional skepticism and objectivity.

Potential solutions

If the auditor's expert raises concerns early in the process, the auditor, in conjunction with the auditor's expert, can request that management address the inherent estimation uncertainty. This may include having management provide further support for the selected point estimate, including additional disclosures in the financial statements related to the estimation uncertainty.

If management is unable to address the estimation uncertainty or does not have the necessary expertise, they may need to engage an external valuation expert in order for the auditor to execute sufficient appropriate audit procedures.

The auditor should also assess whether there is a significant control deficiency and if it should be escalated and communicated to those charged with governance.[25]

23 CAS 540, paragraph 27.
24 CAS 540, paragraph A117.
25 CAS 540, paragraphs 38 and A147.

Learn more

CBV Institute offers practical resources to support auditors and financial statement preparers applying fair value measurement and financial reporting standards. For more information, visit CBV Institute's website.

CPAB continues to monitor emerging issues through our inspections and share our observations through various communications. For more information, visit CPAB's website.