



# **THE ROLE OF THE EXTERNAL AUDITOR IN DETERMINING THE FAIR VALUE VALUES ACCORDING TO THE AUDITING STANDARD NO. (540)**

## **AN ANALYTICAL STUDY OF IRAQI AUDIT COMPANIES**

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<b>Article history:</b>	<b>Abstract:</b>
<b>Received:</b> 20 <sup>th</sup> November 2022 <b>Accepted:</b> 20 <sup>th</sup> December 2022 <b>Published:</b> 30 <sup>th</sup> January 2023	The research aims to demonstrate the role of the external auditor in verifying the validity of the estimates of the value of the material evidence by the Department under the International Audit Standard No. ( 540), which proved the existence of a response method between the software risk and the need and existence of the audit evidence when the audit was carried out on special equipment for microwave equipment The following interview was conducted directly in the form of a report from the Commercial Bank and a tool of the board of directors indicating that the external audit mechanism is based on the international audit ( 540 ) language of the Department of Finance and technical assessment the fair value of the audit reports is based on the quality of the audit reports and is determined by the risk of identifying errors or material misstatements in the financial statements

**Keywords:** fair value estimates, warranties, risks of material misstatement, professional uncertainty.

### **INTRODUCTION**

The auditor's report is considered one of the most important concerns of users of financial reports, as it helps to reduce the gap in their expectations, as the role of the external auditor is based on understanding the activity of the economic unit, including knowing the level of quality of the internal control system, and thus the auditor is able to identify the risks of errors or material misstatements of the fair value in order to develop More consistent auditing procedures, and due to the updates that took place in the accounting field related to the fair value through the issuance of the standards that regulate the accounting work represented by the International Accounting Standards and the International Financial Reporting Standards, This necessitated the importance of the auditors keeping pace with the updates of the accounting processes through the issuance of International Standards Auditing to reach solutions and solutions to some of the problems related to auditing the developed accounting foundations and methods because the current qualification of the auditors is in increasing need of adequate support and development. In order to express an opinion and judge the extent of the credibility and transparency of

the economic unit's transactions. As a result, international auditing standards were issued, including Standard No. (540), so the research aims to answer the following question: Does the external auditor's knowledge of the methods and methods of collateral evaluation enhance the effectiveness of professional skepticism and reduces the risks of not discovering errors or material misstatements when auditing the financial statements?

### **LITERATURE REVIEW AND PREVIOUS STUDIES**

The study (Oyewo & Babajide / 2019) included the post-implementation challenges for measuring fair value - International Financial Reporting Standard No. (13) in Nigeria, where the study concluded that the most severe challenge to fair value estimates is the scarcity of information to evaluate the elements and the magnitude of these challenges appears to be A. Although the characteristics of the auditing firm are similar affecting the perception of the challenges, there is the first agreement that the manipulation of the values of assets and liabilities without a market price during estimation, and taking advantage of the lack of market information on assets/liabilities by managers The manipulation of financial statements,



and the low level of training and scientific qualification of auditors are the most prominent challenges facing auditing fair value estimates, while 2017 included examining whether auditors differ in opinion (Al, Glover, et al., 2017) on the adequacy of audit evidence when auditing fair value estimates. complex, and to identify the relationship of this problem with the expectations gap using the analytical descriptive approach The study recommended the need for auditors to understand all the models used in measuring fair value, especially their shortcomings, by reviewing the research of academics, valuation experts, and agencies concerned with fair value evaluations and management.

#### **A- Estimates of the fair value of collateral**

Guarantees are considered one of the policy policies before economic units for the purposes of reductions through the use of those economic guarantees (Needles & et. al., 2011: 448) There are several forms of guarantees such as cash guarantees, securities, letters of credit, real estate, amounts receivable, inventory and other financial assets and communications Credit preparation (Cenciarelli et al., 2018: 12) Where the fair value of the collateral affects the calculation of the provision for credit losses for the economic unit, and the collateral is re-evaluated periodically, while the cash collateral is required to be evaluated on a daily basis through the use of active market data to evaluate the financial assets held Assurance ( Elliott: 2011:85 ), Where it is required that the auditor be interested in examining the validity of the fair values of the collateral and what appears in the financial statements to ensure that there are no material misstatements that affected the total provision for expected credit losses (Abdullatif:2016:15), and the measurement of fair value estimates depends on assumptions and models determined by management, and these assumptions are intended to be Inputs for the accounting estimate that are not based on clear market prices or formulas, under conditions of uncertainty (Al-Rahamneh, 2018:89-98 ) For example, the administration uses its own authority when estimating the third level of financial instruments for the purpose of obtaining an opportunity in managing capital and profits (Kohlbeck , 2017: 27-39 ) and thus is a fertile field for the bias of that administration, whether intentionally or unintentionally, what results from This is an unfair measurement and presentation of the results of the unit's business and its financial position, and the distortion of profits and property rights Therefore, auditors are required to evaluate the reasonableness of assumptions used by management in preparing

estimates, and pay attention to the contradiction of relevant evidence, since uncertainty related to the reasonableness of assumptions allows for management bias, which may lead to material errors (Backof, 2018: 1798-1815).

#### **B- Auditing the accounting estimates of the fair value according to the International Auditing Standard (540)**

International Auditing Standard (540) dealt with the procedures related to auditing (accounting estimates, including fair value estimates and related disclosures) in the tasks of auditing financial statements (Bratten et, al: 2013:20 ), where the standard was based on clarifying the positive relationship between implicit risks And the size or quantity of evidence, in other words, the higher the risks, the more evidence that must be obtained (Hay, et al.2014:28), because some items of the financial statements cannot be accurately measured, but can only be estimated, and the degree of confidence in Accounting estimates depend on the nature and reliability of information available to management (Suprenyam, 2009:76) , The objective of measuring accounting estimates varies according to the item that requires its measurement and reporting, according to the applicable accounting system, accounting rules and related standards, given that the objective of some accounting estimates is to predict the outcome of an event or transaction or, one case that leads to the preparation of an estimate, Accounting ( IFAC:2015,ISA540:470 ), while fair value estimates differ. Measurement in it and expressed in the value of a current transaction or any item in the financial statements depending on the conditions prevailing at the time of measurement (IASB, 2018:60), and the audit standard (540) explains that the difference between the result of the accounting estimate with the amount originally recognized or disclosed For a specific item in the financial statements that do not necessarily represent an error in the financial statements, because this case applies to accounting estimates at fair value, and the results that are observed are often affected by events after the measurement date for the objectives of the financial statements (Dennis: 2015:7)

#### **C- Testing research hypotheses**

- 1- The use of evaluation methods by the external auditor when auditing fair value estimates contribute to reducing the risks of not discovering errors or material misrepresentations when auditing the financial statements.
- 2- The external auditor's knowledge of the methods and methods for evaluating the fair



value estimates of collateral enhances the effectiveness of professional skepticism.

**D- The role of the external auditor in auditing collateral evaluation procedures**

We review the value of the guarantees shown in the special financial reports of a sample of

private commercial banks and analyze the opinion of the external auditor about the validity of the fair value of those guarantees for the period from (2019 to 2021), which was represented by the following banks:

**- National Bank of Iraq**

Table No. (1) Auditing the impact of the fair value of collateral - amounts in thousands of dinars

the year	2019	2020	2021
Direct credit facilities	194.222.357	349.694.241	907.392.417
Interest in suspense and allowance for credit losses are deducted	( 7.605.454 ) ( 17.652.731 )	( 10.634.773 ) ( 21.460.832 )	( 12.508.256 ) ( 28.270.237 )
Net direct credit facilities	168.964.172	317.598.636	866.613.924
The fair value of collateral for individuals and companies	42.668.686	76.428.307	136.123.397
The ratio of collateral coverage to the loan amount in order to reduce risks	21%	21%	15%

**Source / prepared by the researchers based on the bank's published financial statements.**

Through table (1), it is clear that the percentage of guarantee coverage for default risks has decreased compared to the total contractual value of the facilities, as it reached (15%) at the end of 2021, noting that the type of guarantees varied between real estate guarantee, traded shares, and cash guarantees. As for the auditor's opinion about Auditing the fair value of the collateral and the aspects that were not included in the auditor's report were the following:

Table (2) aspects that were not included in the auditor's report on collateral evaluation

Auditor's opinion	Aspects not included in the auditor's report
<ul style="list-style-type: none"> <li>- The balance of the provision for suspended interest (suspend to be paid) increased during the year 2020 compared to the previous year by (3,029,319) thousand dinars, to become (10,634,773) thousand dinars as a result of the increase in non-performing credit facilities, which amounted to (32,908,478) thousand dinars Iraqi, i.e. (9.41%) of the total credit facilities as on (31/12/2020) compared to (21,566,775) thousand Iraqi dinars, i.e. (11.10%) of the total direct credit facilities as on (31/12/ 2019).</li> <li>- The credit facilities, as of (12/31/2021), amounted to (37,250,118) thousand Iraqi dinars, and after deducting the suspended interest, they amounted to (24,741,862) thousand dinars, representing (3%) of the total direct credit facilities. We recommend the necessity of following up and collecting these late facilities and addressing the reasons for the delay in their payment.</li> </ul>	<ul style="list-style-type: none"> <li>- The auditor's opinion was limited to analyzing and comparing the total non-performing credit facilities relative to the balance of direct credit facilities.</li> <li>- The report did not indicate that the basis for evaluating the fair value of the collateral was tested.</li> <li>- The extent to which the bank's management is committed to conducting a periodic evaluation of collateral has not been ascertained, in addition to examining the accuracy of estimating the fair value of collateral on the date of preparing the statement of financial position..</li> <li>- It has not been ascertained that the value approved by the administration is whether it is based on the fair value in its total value or on the basis of a certain percentage of the fair value of the collateral when calculating the provision for expected credit losses.</li> <li>- It is not clear that the auditor has conducted the comparison and tested the method of forming the provision for expected credit losses to ensure that there are no errors or material misrepresentations that may result from an incorrect estimate of the fair value of the collateral.</li> </ul>



Through what is included in Table (2), there is no indication that the auditor is aware of the risks arising from the possibility of inaccurate estimates of the fair value of the collateral, which directly affect the calculation of the expected credit losses provision, which requires that the auditor be aware of the impact of inaccuracy in the evaluation and calculation in order to improve doubt. professional he has.

**- Mansour Investment Bank**

Table No. (3) Auditing the impact of the fair value of collateral - amounts in thousands of dinars

the year	2019	2020	2021
Direct credit facilities	142.577.759.156	137.915.781.809	149.940.566.666
Interest in suspense and allowance for credit losses are deducted	(17.743.073.018 ) ( 15.707.661.514 )	( 20.764.335.858 ) ( 14.479.787.324 )	( 18.514.771.866 ) ( 9.195.528.683 )
Net direct credit facilities	109.127.024.624	102.671.658.627	27.136.047
The fair value of collateral for individuals and companies	0	0	0
The ratio of collateral coverage to the loan amount in order to reduce risks	0	0	0

Source / prepared by the researchers based on the bank's published financial statements

Table No. (3) shows that the bank's management did not disclose the estimated fair value of the guarantees against the loans, in addition to not taking sufficient measures to reduce the potential risk of default. The auditor's opinion on the fair value of the guarantees was as shown in Table (4) below:

Table (4) The auditor's opinion and aspects that were not included in his report on collateral evaluation

Auditor's opinion	Aspects not included in the auditor's report
<ul style="list-style-type: none"> <li>- The guarantees provided by some customers are still personal guarantees in addition to a check and a bill of exchange. We recommend obtaining sufficient and reliable guarantees.</li> <li>- The provision for expected credit losses was calculated in accordance with the instructions issued by the Central Bank of Iraq.</li> </ul>	The auditor did not refer, in his report, to testing the validity of the fair values recorded in the bank's records of guarantees.

Table (4) shows that the audit procedures for the auditor did not include examining the impact of the accuracy of the collateral evaluation compared to the expected credit losses provision in order to avoid any errors or material misrepresentations that might affect the composition of the aforementioned provision.

**- Iraqi Commercial Bank**

Table No. (5) Auditing the impact of the fair value of collateral - amounts in thousands of dinars

the year	2019	2020	2021
Direct credit facilities	32.150.410	43.386.710	50.003.592
Interest in suspense and allowance for credit losses are deducted	( 10.732.594 ) ( 9.971.167 )	( 13.739.282 ) ( 10.806.777 )	( 13.745.684 ) ( 9.121.86 )
Net direct credit facilities	11.446.640	18.840.651	27.136.047
The fair value of collateral for individuals and companies	12.119.825	12.683.696	2.284.500
The ratio of collateral coverage to the loan amount in order to reduce risks	37%	29%	4%

Source / prepared by the researchers based on the bank's published financial statements



Through table (5), it is clear that the Commercial Bank obtained financial guarantees from the borrowers in exchange for the credit facilities they obtained, but the value of the facilities granted is not equal to a low coverage rate, as it reached the lowest value of a financial guarantee during the year 2021 amounting to (2,284,500) thousand dinars, at a rate of (4%) Noting that the financial guarantees provided by individuals and companies varied between (cash guarantees, real estate guarantees, and mortgaged shares). Table No. (6) shows the analysis of the auditor's opinion as shown below:

Table (6) The auditor's opinion and aspects that were not included in his report on collateral evaluation

<b>Auditor's opinion</b>	<b>Aspects not included in the auditor's report</b>
<p>There is a possibility that the recorded impairment allowance may not be accurate, whether using inaccurate data or using unreasonable assumptions. The following procedures have been taken:</p> <ul style="list-style-type: none"> <li>- Examining the nature of credit facilities portfolios, in addition to examining the internal control system</li> <li>-The credit losses model was evaluated and the focus was on the compatibility of the model with the requirements of the Financial Reporting Standard (9 )Evaluate the appropriateness of rating stages and the reasonableness of calculating credit exposure at exposure.</li> <li>- Discussing with management the future assumptions used by it in calculating expected credit losses.</li> </ul>	<ul style="list-style-type: none"> <li>- The auditor did not make it clear that the evaluation of the validity of the fair value estimates of the financial guarantees and the method used in the evaluation was done and whether they were subjected to a specialized evaluation committee or were they evaluated internally.           <ul style="list-style-type: none"> <li>-The level of commitment of the bank's management to the periodic evaluation of real estate collateral, in addition to the daily evaluation of cash collateral, has not been ascertained</li> </ul> </li> <li>-It requires the auditor to submit a recommendation regarding the weak coverage of the value of the financial guarantees in relation to the total value of the remaining credit facilities owed by the borrowers, which increases the risk of defaulting on payment.</li> <li>- It requires examining and analyzing the accuracy of evaluating financial guarantees and its impact on calculating the probability of default, which is reflected in the composition of the expected credit losses provision.</li> </ul>

Schedule No. (6) Failure to inform the auditor of the validity of the collateral evaluation, which improves his professional doubts, which are reflected in the quality of the reports submitted by him

**-Bank of Baghdad**

Table No. (7) Checking the impact of the value of the guarantees - the value is in thousands of dinars

<b>the year</b>	<b>2019</b>	<b>2020</b>	<b>2021</b>
Direct credit facilities	188.244.891	196.178.258	178.035.358
Interest in suspense and allowance for credit losses are deducted	( 7.702.983 ) ( 30.939.190 )	( 11.696.827 ) ( 10.806.777 )	( 12.463.307 ) ( 43.935.769 )
Net direct credit facilities	149.602.718	141.629.918	121.636.282
The fair value of collateral for individuals and companies	202.853.378	331.718.275	288.033.894
The ratio of collateral coverage to the loan amount in order to reduce risks	%100.07	%100.70	% 100.61

Source / prepared by the researchers based on the bank's published financial statements.

Through table (7), the rate of financial coverage of risks at the Bank of Baghdad is more than (100%), and the year 2020 was the highest rate of (100.70%) of the value of credit facilities, as the guarantees received by the bank varied between (gold insurance,

cash insurance, and guarantees real estate) Real estate guarantees constituted the largest percentage, and table (8) shows the opinion of the auditor regarding auditing the values of these guarantees, as follows:



Table (8) The auditor's opinion and aspects that were not included in his report on collateral evaluation

Auditor's opinion	Aspects not included in the auditor's report
<ul style="list-style-type: none"> <li>- During the year 2019, the percentage of non-performing facilities amounted to (79.7%) of the total direct credit facilities.</li> <li>-Real estate guarantees for the year 2019 amounted to an approximate amount of (174,902,083) thousand dinars on the date of the balance sheet, which represents the contractual value of the guarantees on the date of granting the facilities, as the fair value of these guarantees has not been re-evaluated. We recommend a re-evaluation of real estate guarantees.</li> <li>- Non-performing credit facilities constituted (90%) of the total balance of credit facilities for the year (2020) amounting to (196,178,258) thousand dinars, which requires analysis and study and collection of amounts from the relevant parties.</li> </ul>	<ul style="list-style-type: none"> <li>- It did not appear in the auditor's report that the value of the financial guarantees for the year 2020 was disclosed at the contractual value and not at the fair value, as indicated by the bank's additional clarifications for the year ending on (12/31/2020), which may lead to material errors in calculating the loss allowance. expected credit.</li> <li>- The auditor did not ensure the efficiency of the collateral evaluation system, whether financially, technically or legally, as a secondary source in reducing credit risks, based on the risk management controls in commercial banks issued by the Central Bank of Iraq.</li> <li>- The auditor did not verify (the method of calculation, the information used, the results of the calculation), based on the instructions of the Central Bank of Iraq.</li> </ul>

Table No. (8) shows that the auditor's practices of professional skepticism were not at the required level regarding reviewing the procedures for evaluating those guarantees as a result of not having a comprehensive perception of the risks of inaccuracy in evaluating the guarantees.

We note, through analyzing the opinion of the external auditor and testing the research hypotheses, to show the stability and verification of the research hypotheses, as follows:

- The external auditor's use of valuation methods when auditing fair value estimates contribute to reducing the risk of not discovering errors or material misrepresentations when auditing the financial statements.

- The external auditor's knowledge of the methods and methods for evaluating the fair value estimates of collateral enhances the effectiveness of professional skepticism

## F: RESULTS

1. The reports of the auditors related to the activity of commercial banks indicate that the external auditor does not have sufficient knowledge of the rationale on which the management relied in estimating the fair value of the collateral.

2. The external auditor's mathematical re-calculation of the fair values and ensuring the validity of the inputs approved by the bank's management in evaluating collateral and technical knowledge of valuation methods limit the risks of non-discovery.

3. The auditor's goal of testing the accuracy of the accounting measurement is for the purpose of obtaining a reasonable indication of the results that are reached, whether they are similar or significantly different, given that those results that are observed are often affected by events after the measurement date.

4. For the fair value estimates whose implicit risks are large, the external auditor must verify the reasonableness of those estimates by applying International Auditing Standard No. (540) to obtain appropriate evidence and an opinion on the reasonableness of those estimates in order to enhance the quality of financial reports.

5. The need to include audit procedures determining the percentage of implicit risks discovered by the external auditor because of their impact on the volume of evidence.

6. The auditor should conduct the comparison and test the method of forming the provision for expected credit losses in order to limit the



occurrence of errors or material misrepresentations that may result from the incorrect estimation of the fair value of the guarantees provided against direct credit facilities.

7. The auditors use professional skepticism because it is considered a means to protect them against any future risks that may occur with the aim of providing what the users of the financial statements need in the auditor's report, which is to make their decisions on the basis of data characterized by honest representation.
8. The efficiency of the system for evaluating the fair value of collateral, whether financially, technically, or legally, is confirmed as an important source in reducing credit risks, based on the risk management controls in commercial banks issued by the Central Bank of Iraq.

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