Case 22-9c

Auditing an Accounting Estimate — Goodwill

Introduction

This case illustrates how to audit an accounting estimate; in this instance, management's assertion regarding whether the goodwill asset at a client continues to have a fair value greater than its carrying value. Specifically, the case focuses on possible substantive procedures to test the method(s), significant assumption(s), and data used by management, and it introduces the concept of evaluating contradictory evidence.

This case study uses a fictional company and a financial statement audit of that company. The case assumes the auditor has already completed its risk assessment procedures and has also obtained an understanding of internal control and the company's process for testing goodwill for impairment. The facts obtained from those procedures have been summarized, and risks of material misstatements (RoMMs) have been provided. Background information about the fictional company is provided along with relevant discussion questions.

Note that there are three approaches to testing an accounting estimate:

1. Test management's process used to develop the accounting estimate.
2. Develop an independent expectation for comparison to the company's estimate.
3. Evaluate audit evidence from events or transactions occurring after the measurement date (balance sheet date).

The solution to this case is based on an approach of testing management's process. Refer to the PCAOB and ISA professional pronouncements listed in the solution document; specifically, see the following topics and the paragraphs where they are discussed:

- Method(s):
  - PCAOB AS 2501, paragraphs .10 and .11.
  - ISA 540, paragraph .23.
- Significant assumptions:
  - PCAOB AS 2501, paragraphs .15 through .18.
  - ISA 540, paragraph .24.
- Data:
  - PCAOB AS 2501, paragraphs .12 through .14.
  - ISA 540, paragraph .25.

- Contradictory evidence:
  - PCAOB AS 2501, paragraph .05.
  - ISA 540, paragraphs .18 and .34.

Background

Global Restaurants Incorporated ("GRI" or the "Entity") is a public entity with a December 31 fiscal year-end. GRI is one of the largest restaurant holding companies in the world and operates in over 50 countries. GRI has total assets of approximately $10 billion. GRI management has defined three operating segments that are geographically oriented: (1) North America, (2) Europe, and (3) Other.

The North America operating segment includes two reporting units: Fast Casual and Fine Dining. For purposes of this example, consider only Fast Casual and assume that it represents a reporting unit for purposes of testing goodwill for impairment (the components meet the definition of a reporting unit or cash generating unit under U.S. GAAP or IFRS® Accounting Standards).

The overall Fast Casual market has seen huge gains in the past five years, general economic conditions in the North America operating segment are stable, unemployment is low, and economists expect modest growth in the overall economy in the next few years. There is no indication that the restaurant industry will be affected significantly by economic conditions in the near future.

Management tests all reporting units for impairment on July 1 using various valuation techniques further described below. Materiality for GRI is $25 million.

There are relatively robust accounting and disclosure requirements related to this accounting estimate; however, the information is readily available and has few complexities.

Additional case facts relevant to the annual impairment test for the Fast Casual reporting unit include:

- To determine fair value for the reporting unit, management has selected two equally weighted valuation techniques: a discounted cash flow (DCF) method and a guideline public company market approach. These fair value methods are consistent with the methods used for the Fast Casual reporting unit in prior years, and it is consistent with the Entity's peers.
- The DCF is based on internal forecasts (developed using historical financial data) that are subject to a rigorous process and management has demonstrated an ability to accurately forecast. While largely consistent with forecasts used for other internal

analysis and tracking, the forecasts used in the goodwill DCF are modified before being used elsewhere.

- Management is using a projected revenue growth rate (significant assumption) that is consistent with industry expectations and historical results.

- The engagement team has identified the following RoMMs:*

RoMM (Method)	The method utilized to determine the fair value of the reporting unit is not reasonable in the context of the applicable financial reporting framework; the method selected is inappropriate, or the method is inappropriately applied.
RoMM (Data)	The historical financial information used to develop the estimate (1) is not reasonable in the context of the applicable financial reporting framework, (2) is not relevant and reliable, or (3) has been misinterpreted.
RoMM (Assumption)	The projected revenue growth rate used to develop the estimate is (1) not reasonable in the context of the applicable financial reporting framework, (2) inconsistent with other assumptions and/or the entity's business activities, or (3) does not align with the entity's intent and ability to carry out specific courses of action.

*Note that other RoMMs would likely be relevant based on the case facts presented; however, they are not illustrated for purposes of this case.