Revision in auditing of accounting estimates

This article aims to:
Provide an overview of the revised international standard on auditing for accounting estimates.

Introduction
Developments in the business environment and introduction of new accounting standards have given rise to a greater use of accounting estimates. This is particularly in case of IFRS 9, Financial Instruments, which requires banks and other financial institutions to adopt the Expected Credit Loss (ECL) model for accounting for loan loss provisions, which fundamentally changes the way that banks and other entities account for their loan assets and other credit exposures. These management estimates could be complex and involve judgements, and accordingly, they need to be reported appropriately and be robustly challenged. The International Auditing and Assurance Standards Board (IAASB) had initiated outreach activities and it was highlighted to them that auditing accounting estimates is a key area where enhanced standards were needed to derive improved audit performance.

With this view, IAASB revised the International Standard on Auditing (ISA) 540, Auditing Accounting Estimates and Related Disclosures (ISA 540 (Revised)) in October 2018. The revised auditing standard would enable auditors appropriately deal with increasingly complex accounting estimates and related disclosures. It establishes robust requirements for auditing accounting estimates and provides detailed guidance which is expected to foster audit quality. The guidance requires auditors to perform appropriate procedures in relation to accounting estimates and related disclosures.

ISA 540 (Revised) is applicable to audits of financial reporting periods beginning on or after 15 December 2019, although early adoption is permitted and encouraged. Some of the key features of the revised auditing standard are given in figure 1 on the next page.

1. ISA 540 (Revised) overrides the extant ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
Examples of accounting estimates related to classes of transactions, account balances and disclosures include:

- Inventory obsolescence
- Depreciation of property and equipment
- Valuation of infrastructure assets
- Valuation of financial instruments
- Outcome of pending litigation
- Provision for ECL
- Valuation of insurance contract liabilities
- Warranty obligations
- Employee retirement benefits liabilities
- Share-based payments
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets
- Impairment of long-lived assets or property or equipment held for disposal
- Non-monetary exchanges of assets or liabilities between independent parties
- Revenue recognised for long-term contracts.

Although ISA 540 applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by ISA 540 will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be low based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive.
Overview of ISA 540 (Revised)

Key concepts introduced by ISA 540 are as follows:

Risk assessment

ISA 540 (Revised) focusses on determining what drives the risks of material misstatement of an accounting estimate at the assertion level by obtaining an understanding of the entity and its environment, including the entity’s internal control revolving around the estimate. An auditor would need to perform procedures to obtain an understanding to the extent necessary to provide an appropriate basis for identification and assessment of risks of material misstatement.

Subsequently, the auditor’s further audit procedures should be responsive to the assessed risks of material misstatement at the assertion level and may include any of the three testing approaches (individually or in combination) as given below:

- Audit evidence from events occurring up to the date of the auditors’ report
- Testing how management made the accounting estimate or
- Developing the auditors’ point estimate or range.

While performing risk assessment procedures, auditors are required to separately assess inherent risk and control risk of an accounting estimate at assertion level. For significant risks identified, the auditor would obtain an understanding of the entity’s controls, including control activities, relevant to that risk.

Testing operating effectiveness of controls

While designing and performing tests to obtain sufficient appropriate audit evidence, auditors may consider testing the design and implementation and the operating effectiveness of relevant controls if as per the auditor’s expectation, the controls are operating effectively or substantive procedures alone cannot provide sufficient appropriate audit evidence.

Inherent risk factors

Inherent risk related to an accounting estimate is the susceptibility of an assertion about the accounting estimate to material misstatement, before consideration of controls. Inherent risk results from inherent risk factors, which include:

- **Complexity:** Complexity may be inherent in the process of making an accounting estimate. There may be complexity in the methods, models or data (for example, when data is difficult to obtain). Greater complexity in the models and methods may require specialised skills or knowledge.

- **Subjectivity:** Subjectivity reflects inherent limitations in the knowledge or data reasonably available about valuation attributes. Management judgement is required in determining certain matters that involve subjectivity.

- **Estimation uncertainty:** Estimation uncertainty is the susceptibility to a lack of precision in measurement of an estimate. It often arises due to constraints on the availability of knowledge or data.

- **Other inherent risk factors:** Other inherent risk factors include the extent to which the estimates are susceptible to misstatements due to management bias or fraud, changes in financial reporting requirements, and other factors.

The assessment of inherent risk depends on the degree to which inherent risk factors affect the likelihood or magnitude of misstatement, this varies on a scale that is referred to as the spectrum of inherent risk. The relevance and significance of inherent risk factors may vary from one estimate to another, for example:

- Accounting estimates of ECLs are likely to be complex because the ECLs cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for ECLs are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgements about future events or conditions. Similar considerations apply to insurance contract liabilities.

- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
• Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgement, for example, an accounting estimate that requires a single critical judgement about a liability, the amount of which is contingent on the outcome of the litigation.

**Scalability**

ISA 540 (Revised) is intended to apply to all estimates from complex calculations, which require the use of forward looking information for computation of ECLs, to a more straightforward estimation of the expected useful life of an asset. ISA 540 (Revised) acknowledges that the degree to which an accounting estimate is subject to estimation uncertainty varies substantially. Accordingly, the nature, timing and extent of the risk assessment and further audit procedures would vary in relation to the estimation uncertainty and the assessment of the related risks of misstatement. Thus, the assessed risks of material misstatement would affect the persuasiveness of the audit evidence needed (i.e. higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be) and influence the approach the auditor selects to audit an accounting estimate.

**Professional skepticism**

The IAASB recognises the central role that professional skepticism plays in auditing accounting estimates, therefore, several key principles have been inculcated in ISA 540 (Revised) to enhance the application of professional skepticism. Some of the key provisions are:

• Enhanced risk assessment requirement: The importance of professional skepticism increases when the accounting estimates are affected by a greater degree of the inherent risk factors or when there is greater susceptibility to misstatement due to management bias or fraud; and

• ‘Stand back’ provision: All audit evidence should be obtained in an unbiased manner, and the evidence, whether corroborative or contradictory should be evaluated to determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

**Concept of reasonable**

ISA 540 requires the auditor to evaluate, based on the audit procedures and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. According to the standard, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately including those that address:

• The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity.

• The selection of management’s point of estimate, and

• The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

**Management experts**

For estimates where application of specialised skill or knowledge is required, the management may engage an expert (for example, where a specialised matter requires estimation or where the estimate involves a complex model). ISA 540 (Revised) states that assumptions that may be made or identified by a management’s expert become management’s assumptions when used by management in making an accounting estimate. Accordingly, the auditor will be required to apply relevant risk assessment procedures when evaluating the work of the expert.

**Disclosures**

Some of the accounting estimates may have a substantial impact on the financial statements of entities and involve significant management judgement. For example, while computing the ECLs, banks or other financial institutions need to incorporate forward looking information such as economic or earnings forecast and determine future credit repayments and other cash flows.

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4. In evaluating the work of a management’s expert, the auditor should also consider the expert’s competence, capabilities and objectivity, the auditor’s understanding of the nature of the work performed by the expert, and the auditor’s familiarity with the expert’s field of expertise.
The IAASB noted the increasingly important role of disclosures in financial reporting, particularly with respect to accounting estimates. It noted that, in many cases, disclosures relating to accounting estimates are critical to users’ understanding of the accounting policies applied, the nature and extent of estimation uncertainty, and key judgements and other matters relating to accounting estimates, in particular when estimation uncertainty is high. Thus, it requires auditors to evaluate whether the disclosures made in the financial statements are in accordance with the requirements of the applicable financial reporting framework (for example, disclosures pertaining to ECL should be in accordance with IFRS 9), and include details of how the accounting estimate was developed, including the nature, extent and sources of estimation uncertainty.

Communication with those charged with governance

The IAASB recognised the importance of a two-way dialogue between the auditor and those charged with governance. Therefore, it emphasised on communications with those charged with governance or management regarding significant qualitative aspects of the entity’s accounting practices and significant deficiencies in internal control. In addition, it has noted that the auditor may be required by law or regulation to communicate about certain matters with other relevant parties, such as regulators or prudential supervisors.

Documentation

The documentation requirements have been extended to include the auditor’s understanding of the entity and its environment, the assessment and the corresponding response to risks of material misstatements, indicators of possible management bias, and other judgements relating to auditors determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework.

Written representations

ISA 540 (Revised) permits auditors to request written representations from management and when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosure are appropriate to achieve recognition and measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor may also consider the need to obtain representations about specific accounting estimates, including in relation to the method, assumptions, or data used.

Consider this

- The amendment of ISA 540 has brought about consequential amendments to other standards on auditing with regard to risk assessment, documentation, relevance of external information sources as audit evidence and communication with those charged with governance. These amendments will become effective at the same time as ISA 540 (Revised).
- If the auditor’s consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter which needs be reported in the auditor’s report.
- Where the auditor is not able to obtain sufficient and appropriate audit evidence regarding the accounting estimate, he/she should evaluate the implications for the audit or the auditor’s opinion on the financial statements.
- Considering the complications surrounding the accounting estimates in the Indian scenario, we expect similar amendments to be made in the Standard on Auditing (SA) 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures in the near future.