Auditing Estimates and Subjective Accounting Information

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Introduction

Guidance surrounding accounting estimates

Assessing the risk of significant estimates

Historical accuracy

Audit Work: Planning, Designing and performing test work for accounting estimates

Applying professional skepticism to auditing accounting estimates

Practical Examples

Challenges encountered & overcoming them
Accounting Estimate Defined

- An *accounting estimate* is an approximation of a financial statement element, item, or account.
- Or
- An approximation in a financial statement of the amount to be credited or debited on items for which there is **no precise means** of measurement, such as depreciable assets or provisions for a loss from a lawsuit.
- Estimates are based on the **judgment and specialized knowledge derived from past experience**
Auditors Responsibility

• The auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements taken as a whole.

• As estimates are based on subjective as well as objective factors, it may be difficult for management to establish controls over them.

• Even when management's estimation process involves competent personnel using relevant and reliable data, there is potential for bias in the subjective factors.

• Accordingly, when planning and performing procedures to evaluate accounting estimates, the auditor should consider, with an attitude of professional skepticism, both the subjective and objective factors.
Making estimates is an inevitable part of preparing financial statements in order to show them at a reliable value.

These estimates will include some routine matters such as the expected life of property, plant and equipment, estimating appropriate allowances for receivables and some more challenging matters, such as valuation of pension liabilities for a newly acquired subsidiary.

Estimates share one characteristic above all others – they are an attempt to look into the future and are consequently subject to a high degree of uncertainty and so inherent risk of misstatement.
Developing Accounting Estimates - Process

• Identifying situations for which accounting estimates are required.
• Identifying the relevant factors that may affect the accounting estimate.
• Accumulating relevant, sufficient, and reliable data on which to base the estimate.
• Developing assumptions that represent management's judgment of the most likely circumstances and events with respect to the relevant factors.
• Determining the estimated amount based on the assumptions and other relevant factors.
• Determining that the accounting estimate is presented in conformity with applicable accounting principles and that disclosure is adequate.
Internal Control Related to Accounting Estimates-Aspects

• Management communication of the need for proper accounting estimates
• Accumulation of relevant, sufficient, and reliable data on which to base an accounting estimate
• Preparation of the accounting estimate by qualified personnel
• Adequate review and approval of the accounting estimates by appropriate levels of authority
Evaluating Accounting Estimates

• All accounting estimates that could be material to the financial statements have been developed.
• Those accounting estimates are reasonable in the circumstances.
• The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.
Identifying Circumstances that Require Accounting Estimates-Procedures

• Information about changes made or planned in the entity's business, including changes in operating strategy, and the industry in which the entity operates that may indicate the need to make an accounting estimate.

• Changes in the methods of accumulating information.

• Information concerning identified litigation, claims, and assessments.

• Information from reading available minutes of meetings of stockholders, directors, and appropriate committees.

• Information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies.
Evaluating Reasonableness - factors and assumptions

• Significant to the accounting estimate.
• Sensitive to variations.
• Deviations from historical patterns.
• Subjective and susceptible to misstatement and bias.
Guidance on Estimates

• ISA 700 requires that an auditor expresses an opinion in terms of reasonable assurance therefore need a substantial amount of robust evidence to support it.

• It is rather too easy to drop into auditing estimates to a degree where conclusions become that management’s estimates are ‘reasonable’ or even ‘plausible’. Neither of these conclusions mirror the wording used in our actual audit report and so are insufficient to comply with the requirement of ISA 700 and ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.

• Obtaining certainty about the future is impossible, but obtaining evidence to support a reasonable conclusion on likely future outcomes is not.
Guidance on Estimates under ISA 540

• All practices need to be able to audit accounting estimates under this important ISA.

• Although this standard should not be a huge burden on most audits, firms must ensure they understand and apply it properly or they will not have a fully compliant file.

• **Requirement**

  ISA 540 states that the auditor’s objective is to obtain sufficient, appropriate evidence on whether:

  - Accounting estimates are **reasonable**, and
  - Related **disclosures** in the financial statements are **adequate**.
Risk of Material Misstatement of AEs

• The risk of material misstatement of accounting estimates normally varies with;
  • the complexity and subjectivity associated with the process,
  • the availability and reliability of relevant data,
  • the number and significance of assumptions that are made, and
  • the degree of uncertainty associated with the assumptions.
The Risk Model/Risk Assessment
• ISA 540 is built around the risk model in ISAs 315 and 330

Understanding the entity
Following this model, the first step is to demonstrate a detailed knowledge of the estimates including:
  o The requirements of the reporting framework
  o How management identifies issues that give rise to estimates

• How management makes estimates, including:
  o The method or model
  o Relevant controls
  o Use of experts
  o Underlying assumptions
  o Changes from prior periods
  o Management’s assessment of estimation uncertainty
Assessing & Responding to Risk

• The next step is to assess the risk that the estimate is materially misstated, of course, not all risks are equally risky.

• The assessment of risk for, say, depreciation of standard plant and machinery is likely to be very different from, say, the directors’ valuation of an investment property.

Responding to Risk

• Once the level of risk has been assessed, those risks need to be responded to. Therefore the amount of work on each area, the quantity and the quality of audit evidence needed will increase as the risk increases.

• The auditor’s response is graded depending on whether a risk identified is a normal risk or a significant risk. A significant risk is one that the auditor judges to have high estimation uncertainty.

• ISA 540 directs the auditor’s work from a starting point of uncertainty rather than the materiality. The greater the estimation uncertainty, rather than the size of the draft figure, the greater the amount of evidence that the auditor will need to obtain.
Audit Work: Planning the Audit

• A critical first step for the auditor in planning the work is to understand the client’s business and identify where the greatest scope for accidental or deliberate bias in production of estimates exists. This assessment will include a formal and documented assessment of:
  • How the client identifies items subject to estimates and how satisfactory these procedures appear to be.
  • How the client identifies and assesses estimation uncertainty. Estimation uncertainty is ‘The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement’. The greater the estimation uncertainty, the more the client will need to explore the effect of different models and assumptions to make an appropriate estimate.
  • How the client has identified new items that are subject to estimates and any existing items subject to estimation but where there may now be a more reliable method of establishing an estimate.
  • The source data used by the client upon which to base an estimate, together with how relevant and reliable that source data appears to be.
Historical Accuracy

• Historically, estimates have arguably mostly been audited by assessing the client’s schedules and determining if they are reasonable. ISA 540 requires a more forensic approach than this.

• Comparison of historical accuracy of management estimates compared with actual outcomes.

• The greater the variance between estimates and eventual outcomes, the greater the risk of error; either by high estimation uncertainty or weak control by management of the process of determining estimates.

Revisit the prior year

• The auditor must revisit estimates used in the prior period to help them carry out their risk assessment in the current period.

• This process is not designed to call into question the previous year’s accounts, but rather to question how accurate they ultimately were, given the results of the current year, as part of understanding how likely the current year’s figures are to being misstated.
Audit Work: Sufficient, Appropriate Evidence

The greater the potential materiality of an item and the greater its estimation uncertainty, the greater the evidence will need to be in order to be sufficient and appropriate to base a conclusion.

For core evidence auditor should:

• Assess and document their own independent assessment of estimation uncertainty for each material, subjectively valued item in the financial statements.

• Assessment of adequacy of controls over determining estimates and whether the controls have worked as specified. For example, if a risk management committee is tasked with approval of all material estimates, is there evidence that this has happened, that its members were properly briefed and competent?

• Inspection of accounting policies used by management to ensure that they comply with the appropriate rules of the GAAP system used.
Audit Work: Sufficient, Appropriate Evidence

- Investigation of outcomes of the **uncertainties after the year-end but before the audit opinion is issued**. If the uncertainty has been settled before the audit opinion has been issued, the uncertainty has effectively been disposed of.

- Comparison of **historical accuracy** of management estimates compared with **actual outcomes**. The greater the variance between estimates and eventual outcomes, the greater the risk of error; either by high estimation uncertainty or weak control by management of the process of determining estimates.

- Verification of any **underlying data** used by management (eg debt default rates by age of debt) to external evidence.

- The auditor must develop their own **point estimate**, or **range of estimates** if a point estimate is not achievable. A point estimate is the auditor’s own assessment of the single most likely value. A range of estimates is the range over which the auditor believes an estimate would be reasonable.
Audit Work: Sufficient, Appropriate Evidence

- Ranges of estimates are normally adequate if their range of values (other than remotely possible values) is within performance materiality. Performance materiality is the figure below which errors noted on audit tests of detail are not cumulatively recorded in the audit files. If their range of values other than remote possibilities falls outside the limit of performance materiality, they represent significant estimation risks and more evidence is required; normally including estimation of a point estimate.

**Should consider need for specialist advice.**

- Obtain written management representations to confirm the auditor’s understanding of management’s intentions.

- Note that management representations alone do not provide sufficient, appropriate evidence. The representation letter should be viewed as a necessary, but insufficient component of the audit evidence.
Applying Professional Skepticism

• A change in method of estimation by management should be treated with skepticism. Changing the methodology used to make an estimate has much the same effect on the financial statements as changing an accounting policy, so the auditor should require evidence that a change in methodology was necessary to produce more reliable estimates.

• Skeptically review assumptions used by management for internal consistency and ensure in accordance with observable market data. For example, if inflation has been built into growth in expected income streams, ensure that all future costs are also estimated allowing for expected inflation.

• There is a high inherent risk of cost estimates being based on today’s costs; thus overestimating net income
Examples of Accounting Estimates

- **Receivables:**
  - Uncollectible receivables
  - Allowance for loan losses
  - Uncollectible pledges

- **Inventories:**
  - Obsolete inventory
  - Net realizable value of inventories where future selling prices and future costs are involved
  - Losses on purchase commitments

- **Revenues:**
  - Airline passenger revenue
  - Subscription income
  - Freight and cargo revenue
  - Dues income
  - Losses on sales contracts

- **Contracts:**
  - Revenue to be earned
  - Costs to be incurred
  - Percent of completion
Examples of Accounting Estimates

- Leases:
  - Initial direct costs
  - Residual values

- Financial instruments:
  - Valuation of securities
  - Trading versus investment security classification
  - Probability of high correlation of a hedge
  - Sales of securities with puts and calls

- Litigation:
  - Probability of loss
  - Amount of loss

- Rates:
  - Annual effective tax rate in interim reporting
  - Imputed interest rates on receivables and payables
  - Gross profit rates under program method of accounting
Examples of Accounting Estimates

- **Accruals:**
  - Property and casualty insurance company loss reserves
  - Compensation in stock option plans and deferred plans
  - Warranty claims
  - Taxes on real and personal property Renegotiation refunds
  - Actuarial assumptions in pension costs

- **Productive facilities, natural resources and intangibles:**
  - Useful lives and residual values
  - Depreciation and amortization methods
  - Recoverability of costs
  - Recoverable reserves

- **Other:**
  - Losses and net realizable value on disposal of segment or restructuring of a business
  - Fair values in nonmonetary exchanges
  - Interim period costs in interim reporting
  - Current values in personal financial statements
• ISA requires an auditor to respond robustly in order to produce a compliant audit file where work notes demonstrate that all estimates have been properly considered.

• Audit of estimates is subject to a high degree of uncertainty thus obligation to provide substantial disclosure of the circumstances giving rise to the uncertainty; so that readers can make up their own mind.
Thank You