ISA 540 (Revised) Auditing Accounting Estimates and Related Disclosures

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Presentation agenda

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- Audit Objectives
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Definitions

1. Accounting estimate is a monetary amount whose measurement is subject to estimation uncertainty.
2. Auditor's point estimate is an amount developed by the auditor to evaluate management's point estimate.
3. Management point estimate is an accounting estimate selected by management for recognition and disclosure in the financial statements.

Definitions

- Management bias relates to management subjectivity.
- Estimation uncertainty refers to exposure to an inherent lack of precision in measurement.

Audit Objectives

- To test for reasonability of accounting estimates and related disclosures.
- Effective date is on or after 15 December 2019.

The auditor is required to test the reasonableness of accounting estimates made by management.

Key Changes

- Enhanced risk assessment procedures; separate assessment of control risk and inherent risk.
- Emphasis on objective based requirement to assess risk of material misstatement; methods, assumptions and data.
- Introduced the concept of inherent risk factors; complexity, subjectivity, lack of precision in measurement and management bias.
- Recognized spectrum of inherent risk to drive scalability.
- Expanded documentation requirement.

Nature of Accounting Estimates

- Are subject to estimation uncertainty.
- Monetary amounts cannot be directly observed
- There is inherent subjectivity and variation in measurement due to differences in assumptions, data and methodology applied.
- Requires assumptions and judgment by management.
- Requires high degree of professional skepticism.
- Are susceptible to misstatement due to inherent risk factors i.e. estimation uncertainty, complexity, subjectivity and management bias.

Examples of Accounting Estimates

- Inventory obsolescence.
- Provision of expected credit losses.
- Depreciation of property, plant and equipment.
- Valuation of financial instruments.
- Sales of securities with puts and calls.
- Outcome of pending litigation.
- Warranty obligations.
- Share-based payments.
- Employee retirement benefits liabilities.
- Impairment of property.

Examples of Accounting Estimates (Cont.)

- Useful lives and residual values.
- Depreciation and amortization methods.
- Probability of loss in litigation.
- Taxes including deferred tax.
- Actuarial assumptions in pension costs and other insurance audits.
- Annual effective tax rate in interim reporting.
- Imputed interest rates on receivables and payables.

Risk Assessment Procedures

- Obtain proper understanding of the entity relevant to accounting estimates.
- Review of previous accounting estimate to assess effectiveness of management estimation process.
- Ensure compliance with applicable financial reporting and regulatory framework.
- Separately assess inherent risk and control risk.

Material Misstatement

- Evaluate the degree of estimation uncertainty associated with an accounting estimate.
- Determine whether any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.
- Check consistency in application of accounting estimates.
- Evaluate the accounting estimate prepared by management; methods, assumption , data and judgment.

Responses to Risk of Material Misstatement

- Develop auditor's point estimate or range.
- Engage experts with specialized skills or knowledge.
- Evaluate the appropriateness of expert's work before placing reliance.
- check whether the significant assumptions used by management are reasonable.
- Document indicators of management bias and its implication.
- For significant risk with no control testing use both substantive approach and test of details.

Responses to Risk of Material Misstatement (Cont.)

- Test how management made the accounting estimate – data, model, assumption, judgment. Consistency etc.
- Obtain audit evidence up to the point of audit report.
- Document auditor's response when management has not addressed identified estimation uncertainty.
- Communicate with management and those charged with governance about deficiencies in internal control and other relevant matters.
- Obtain written representation from management confirming appropriateness of accounting estimates.

Written Representation

1. That judgments made have considered all relevant information.
2. Consistency and appropriateness of data, method and assumptions used.
3. Specialized skills and expertise applied.
4. No subsequent events that require adjustments.
5. The rationale behind the accounting estimates not recognized or disclosed.

Documentation

- Internal controls related to the accounting estimates.
- Indicators of management bias.
- Significant judgments made to test the reasonableness of the accounting estimates and related disclosures.
- Risk assessment, procedures carried out and the audit conclusion.

Disclosures

- The method of estimation used, model and basis of selection.
- The underlying data.
- Assumptions used.
- Changes made to past assumptions.
- Major sources of estimation uncertainty.
- Limitation of the estimation process.

Interactive Session