Accounting estimates – ISA 540
ISQM1,2 and ISA 220
Quality Management

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Agenda

- ISA 540 – Auditing Accounting estimates
- International Standard on Quality Management 1 (ISQM 1)
- International Standard on Quality Management 2 (ISQM 2)
- ISA 220 - Quality Control for an audit of financial statements

ISA 540 – Auditing Accounting estimates

- Auditor’s objective per ISA 540
- Accounting estimates and examples
- Auditing accounting estimates
- Management representations

Auditor's Objectives

- To obtain sufficient appropriate audit evidence about whether accounting estimates, including fair value estimates, in the financial statements:
  a) Are reasonable;
  b) Related disclosures are adequate; and
  c) Determined in the context of the applicable financial reporting framework.

Auditing Estimates

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- Some financial statement items cannot be measured precisely, but can only be estimated (approximation).
- An **accounting estimate** is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

Examples of Accounting Estimate

- Impairment of loans and receivables
- Provision for obsolete inventory
- Depreciation expense (useful life)
- Valuations of staff gratuities
- Valuation of unquoted shares and investments
- Revenue recognition on percentage of completion
- Warranty claims
- Provisions for litigations
- Income and deferred taxes

Risk assessment procedures on estimates

- Auditors is required to:
  - Understand the requirement of the applicable reporting framework relevant to the estimate
  - Understand how management makes the estimate and the data they use.
  - Perform a retrospective review by reviewing the outcome of the accounting estimate included in prior period financials. Any variance is not necessarily a misstatement, but a basis to refine current and future estimation.

Risk assessment procedures on estimates

The auditor need to have an understanding of the data on which the estimate was based, including:-

- the method used in making the estimate;
- relevant controls;
- whether management has used an expert;
- the assumptions underlying the estimates;
- whether there has been, or ought to have been, a change from the prior period in the methods for making the estimates, and if so, why; and
- how management has assessed the effect of estimation uncertainty.

Auditing Accounting estimates

- Test operating effectiveness of controls over the estimates
- Challenge the assumptions used by management by comparing to industry trends, subsequent events and/or sector analysis relevant to the estimate
- Review management considerations for estimation uncertainty by evaluating:
  a) How management have considered alternative assumptions or outcomes or why they rejected the alternatives
  b) Whether the assumptions used by management are reasonable and supported

Auditing Accounting estimates

- Consider using an expert or specialist to validate assumptions used to make the estimate. Those with experience in a field other than accounting or auditing are considered auditor's experts and ISA 620 applies
- Consider any existence of indicators of management bias in making the estimate
- Evaluate and validate the accuracy of the models used to compute the estimate.

Reviewing significant estimates

- Auditors should be alert to period-end adjusting journal entries.
- Management is responsible for providing evidence to support that:
  - Estimates are reasonable
  - Estimates are presented in conformity with IFRSs
  - Disclosure about estimates is adequate
- Management estimates are based on:
  - Subjective factors
  - Objective factors

Reviewing significant estimates

- Events or transactions useful in identifying and evaluating reasonableness of estimates occur:
  - After the reporting date
  - Before audit report date

- Auditor should focus on **factors** and **assumptions** that are:
  - Significant to accounting estimate
  - Sensitive to variations
  - Deviations from historical patterns
  - Subjective and susceptible to misstatement and bias
  - Inconsistent with current economic trends

Disclosures

- Obtain sufficient appropriate audit evidence about whether disclosures related to accounting estimates are in accordance with the applicable financial reporting framework

- For estimates giving rise to significant risks, also evaluate the adequacy of the disclosure of estimation uncertainty in the context of the applicable financial reporting framework

Documentation

- Document
  - The basis for the auditor’s conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks
  - Indicators of possible management bias, if any

Written representation on assumptions

- The auditor must obtain written representations from management and those charged with governance, saying that they believe **significant assumptions** used in making their accounting estimates are **reasonable**.
- **Written management representation alone do not constitute sufficient appropriate audit evidence**
- The auditor must include in the **audit documentation** the basis for the conclusions about the **reasonableness of accounting estimates** and their disclosure that give rise to significant risks; and **indicators of possible management bias**, if any.

Questions?

ISQM 1

The new quality management approach aims to improve the scalability of ED-ISQM 1 because it requires a firm to **customize** the design, implementation and operation of its system of quality management based on the **nature and circumstances of the firm and the engagements it performs**

Proposed International Standard on Quality Management 1 (ISQM 1)

(Previously International Standard on Quality Control 1 (ISQC 1))

ISQM 1 - Objectives

Objective of the firm

Design, implement and operate a system of quality management

Objective of the system of quality management

Provide the firm with reasonable assurance that:

(a) The firm and its personnel fulfill their responsibilities in accordance with professional standards and applicable legal and regulatory requirements, and conduct engagements in accordance with such standards and requirements; and

(b) Engagement reports issued by the firm or engagement partners are appropriate in the circumstances.

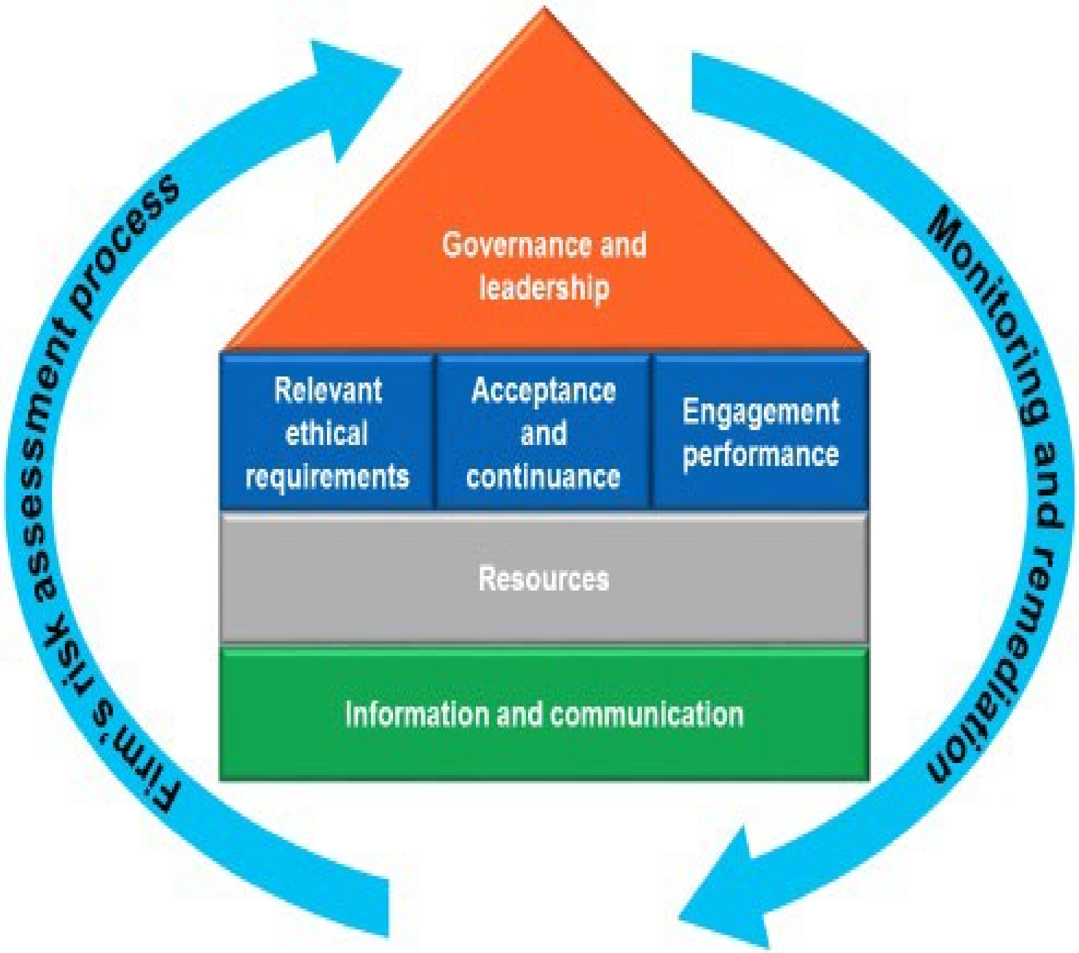
Objective of ED-ISQM 1

The Components of a System of Quality Management

ISQC 1 Components

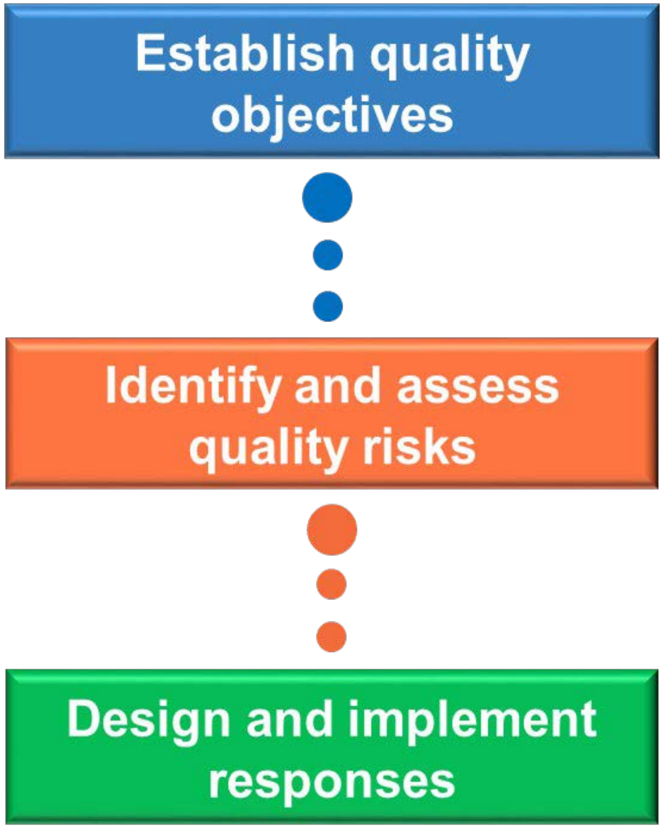
1. Leadership responsibilities for quality within the firm.
2. Relevant ethical requirements.
3. Acceptance and continuance of client relationships and specific engagements.
4. Human resources.
5. Engagement performance.
6. Monitoring.

ISQM 1 Components



The firm's risk assessment processes

- ED-ISQM 1 includes a new approach that focuses firms' attention on risks that may have an impact on engagement quality.
- The firm's risk assessment process is applied to the other seven components of the system of quality management.
- The quality objectives established by the firm consist of objectives that, when achieved by the firm, collectively provide the firm with reasonable assurance that the objectives of the system of quality management are achieved.



Identifying risks

Step 1: Identify the quality risks

Quality risks (the whole population)

Is there a reasonable possibility of the risk occurring?

No

Yes

Would the quality risk *individually* have a significant effect on the achievement of a quality objective(s)?

No

Yes

Would the quality risk *in combination with other quality risks* have a significant effect on the achievement of a quality objective(s)?

No

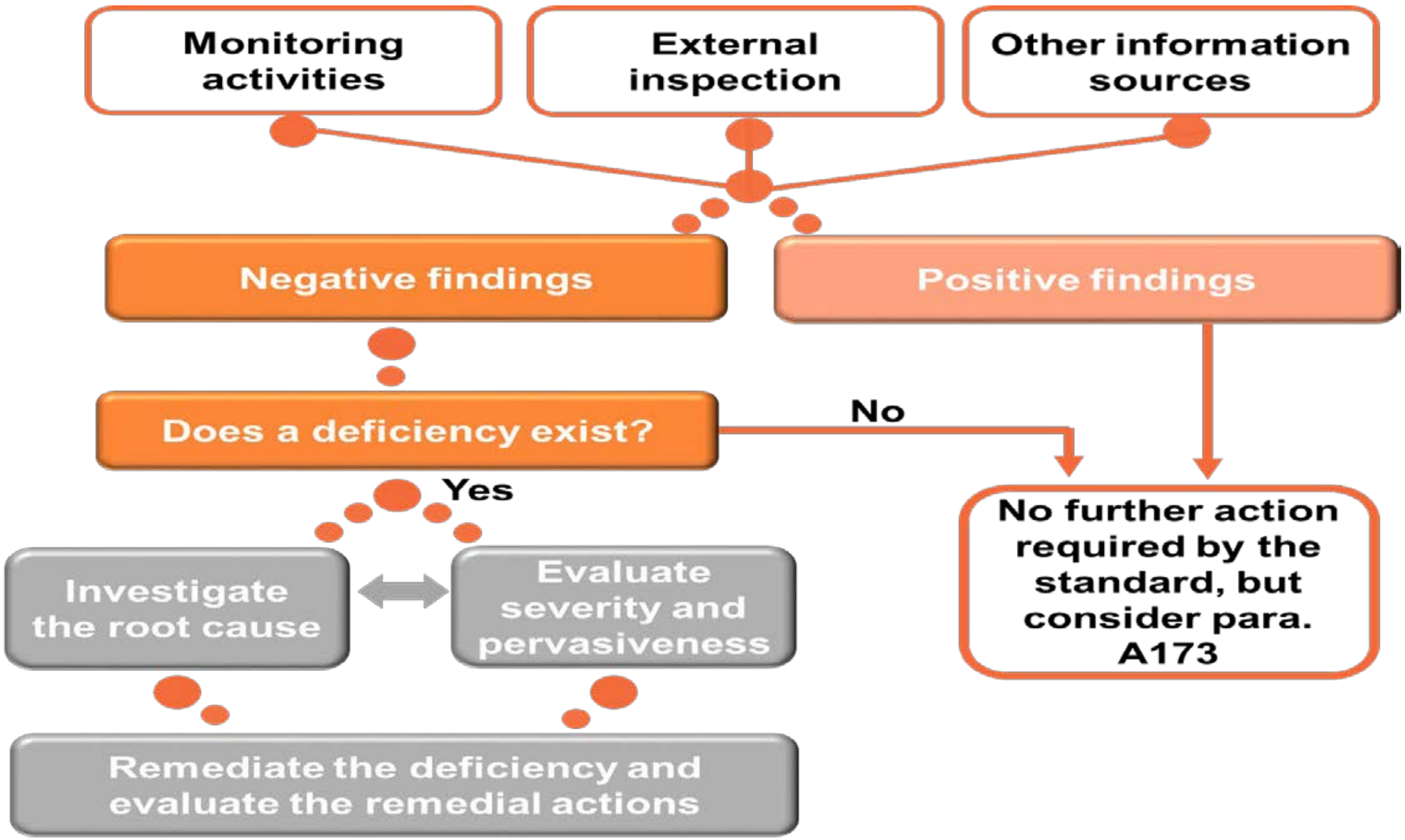
No required further action

Yes

Step 2: Assess the quality risks

Identified quality risk that is required to be assessed:
Assess the quality risk to provide a basis for the design and implementation of the related responses. In doing so, assess the possibility of the quality risk occurring and the effect on the achievement of a quality objective(s).

Evaluating Findings and Identifying Deficiencies



Root Cause Analysis – *ISQM requires* firms to take action to understand the causal factors of inspection findings as a means of improving audit quality.

Information and Communication

- ISQM 1 includes a new component, *information and communication,* which requires the firm to establish an information system and emphasizes the need for effective two-way communication within the firm.
- The IAASB recognizes that firms communicate with external parties in a variety of ways and the communication is continually evolving.
- ED-ISQM 1 requires communication with external parties to be developed in a manner that is adaptable to the circumstances of the firm. The requirements aim to promote the exchange of valuable and insightful information about the firm's system of quality management with the firm's stakeholders.

ISQM 2

- ED-ISQM 2 addresses the firm’s policies or procedures and criteria for the eligibility of an individual to be appointed as an engagement quality reviewer.
- The policies or procedures to include limitations on the eligibility of an individual to be appointed as engagement quality reviewer for an engagement on which the individual previously served as engagement partner.

Proposed International Standard on Quality Management 2 *Engagement Quality Reviews*

ISQM 2 - Benefits

- The requirements for engagement quality reviews currently reside in extant ISQC 1 and ISA 220.
- The IAASB concluded that having a separate standard for engagement quality reviews would provide a number of benefits, including:
  a) Placing emphasis on the importance of the engagement quality review.
  b) Facilitating the enhancement of the robustness of the requirements for the eligibility of EQCR and the performance of the review.
  c) Providing a mechanism to more clearly differentiate the responsibilities of the firm and the engagement quality reviewer.
  d) Increasing the scalability of ED-ISQM 1. A firm may determine that there are no engagements for which an engagement quality review should be performed (e.g., a firm that performs only compilation engagements).

EQCR – appointment and eligibility

ED-ISQM 2 requires a firm's policy on appointment and eligibility of the engagement quality reviewer to address:

- The eligibility of the individual(s) within the firm responsible for the appointment of engagement quality reviewers.
- The eligibility of individuals to assist the engagement quality reviewer in performing the engagement quality review.
- The engagement quality reviewer taking responsibility for the performance of the engagement quality review, including that the work of individuals assisting in the review is appropriate.
- Limitations on the eligibility of an individual to be appointed as engagement quality reviewer for an engagement for which the individual previously served as the engagement partner.

EQCR

Key considerations for the appointment and eligibility of the engagement quality reviewer include:

- Competence and Capabilities, Including Sufficient Time
- Appropriate Authority - a mechanism for the engagement quality reviewer to resolve issues when differences of opinion arise.
- Relevant Ethical Requirements, Including Objectivity – cooling off periods for previous engagement partners
- Use of External Resources to Perform the Engagement Quality Review (eligibility similar to internal appointments)
- Timing of the Engagement Quality Review
- Significant Judgments and Significant Matters
- Documentation

ISA 220 – Quality Control for an Audit of Financial Statements

ISA 220 deals with the responsibilities of the auditor regarding quality control procedures for an audit of financial statements.

It also addresses where applicable the role of the EQCR

ISA 220 – Quality Control for an Audit of Financial Statements

ISA 220 addresses the following requirements:

- The engagement partner is responsible for the overall quality on each audit engagement and:
  - Relevant ethical requirements including independence
  - Acceptance and continuance of client relationships and audit engagements
  - Assignment of engagement teams (appropriate skills)
  - Engagement performance: Direction, supervision, performance and reviews

ISA 220 – Quality Control for an Audit of Financial Statements

ISA 220 addresses the following requirements: (continued)

- The engagement quality control reviewer (EQCR):
  - Required for listed entities and any others determined by the firm.
  - Engagement partner responsible for-
    - ✓ Appointment of the EQCR
    - ✓ Discussing significant matters with EQCR
    - ✓ Not completing auditor's report before EQCR review

ISA 220 – Quality Control for an Audit of Financial Statements

ISA 220 addresses the following requirements: (continued)

- Handling differences of opinion in the team
- Monitoring system of quality control at the firm
- Threats to independence
- Consultation requirements
- Documentation requirements on ethical requirements, conclusions reached on acceptance of clients, etc.

Questions?