

# ISA 540 (effective Dec, 15 2009)

Auditing Accounting Estimates,  
including Fair Value Accounting  
Estimates and Related Disclosures

Simone Luschnik



# Accounting Estimates in the Financial Statements

## SUBJECTIVITY OF ASSUMPTIONS

Useful life of assets

Warranty Provisions

Impairments of Assets

Legal Claims

Allowance for doubtful accounts

Defined Benefit Obligations



NATURE OF  
INFORMATION

ACCEPTANCE OF  
METHOD

RELIABILITY OF  
INFORMATION



Degree of estimation uncertainty

# RMM in conjunction with Accounting Estimates



Degree of estimation uncertainty

affects

Risk of Material Misstatement

## Link to ISA 315.35:

„The auditor shall **identify and assess** the risk of material misstatement at [...] the assertion level [...] to provide a basis for designing and performing further audit procedures.“

## Link to ISA 330.6:

„The auditor shall design and perform further audit **procedures** whose nature, timing and extent are based on and are **responsive to the assessed risks** of material misstatement at the assertion level.“

# RMM in conjunction with Accounting Estimates - examples



## Degree of estimation uncertainty

- accounting estimates
  - arising in non-complex entities (*e.g. usually SME*)
  - that are frequently made and updated (*e.g. useful life of assets*)
  - derived from data that is readily available or observable (*e.g. published interest rate data*)
- Fair value accounting estimates
  - with simple method prescribed by financial reporting framework that is easy to apply
  - based on a well known or generally accepted model (*e.g. personell provisions*)
- accounting estimates
  - relating to the outcome of litigation
- Fair value accounting estimates
  - for derivative financial instruments not publicly traded
  - for which a highly specialized entity developed model is used or for which assumptions or inputs cannot be observed in the market place (*e.g. business valuation*)

# Objective of the auditor

- obtain sufficient appropriate audit evidence
    - accounting **estimates** (including fair value accounting estimates, in the F/S, whether recognized or disclosed) are **reasonable**
    - related **disclosures** are **adequate**
- in context of the applicable financial reporting framework



# Relevant terms and definitions of this standard (ISA 540.7)

- **accounting estimate** – an approximation of a monetary amount in the absence of a precise means of measurement.
- **auditor's point estimate or auditor's range** – the amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.
- **estimation uncertainty** – the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement
- **management bias** – a lack of neutrality by management in the preparation of information
- **management's point estimate** – the amount selected by management for recognition or disclosure in the financial statements as an accounting estimate
- **outcome of an accounting estimate** – the actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate



# Risk Assessment Procedures and Related Activities

- the auditor shall obtain an **understanding** of

**Requirements** of the applicable financial reporting framework relevant to accounting estimates

how management **identifies** transactions, events and conditions that may give rise to the need for accounting estimates<sup>1</sup>

How management **makes the accounting estimates**, and an understanding of the **data** on which they are based, including

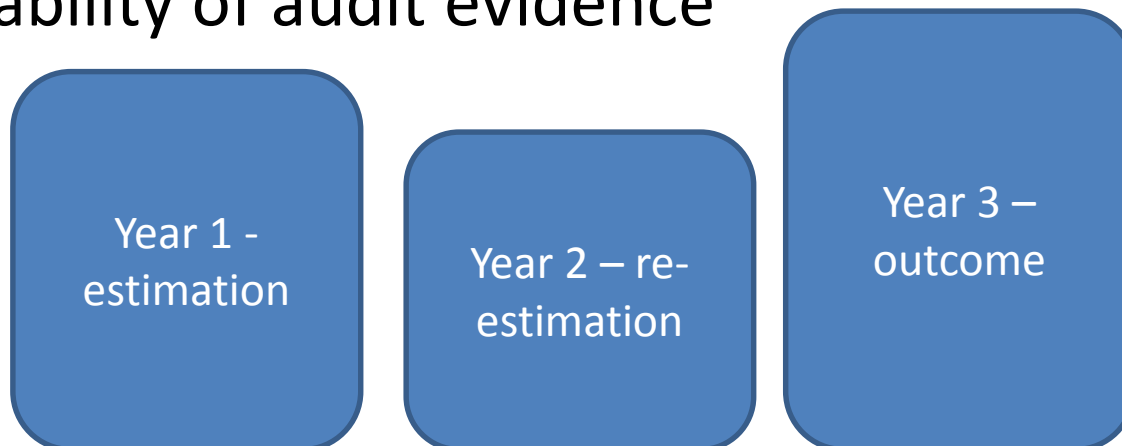
- i) the method / modell
- ii) relevant controls
- iii) use of experts<sup>2</sup>
- iv) underlying assumptions
- v) method changes from the prior period
- vi) assessment of the effect of estimation uncertainty

## **Considerations specific to smaller entities:**

- <sup>1</sup>) less complex transactions due to limited business activities; a single person identifies the need for accounting estimates >> focus on inquiries accordingly
- <sup>2</sup>) early discussions in the audit process with the owner manager about the nature and completeness of accounting estimates assists the owner-manager in determining the need to use an expert

# Risk Assessment Procedures and Related Activities

- review of the **outcome or re-estimation of accounting estimates** included in the prior period financial statements (see also ISA 240.32)
  - analytical or detailed review depending on prof. judg.
- understand reasons for differences, as such
  - ineffective estimation process, management bias, availability of audit evidence





# Identifying and Assessing the Risk of Material Misstatement

- evaluation of the degree of estimation uncertainty associated with an accounting estimate >> significant risks?
  - highly dependent on judgement (outcome of pending litigation, amount and timing of a cash flow dependent on events in the far future)
  - accounting estimates that are not calculated using recognized measurement techniques
  - indication of substantial differences between original accounting estimate and actual outcome
  - fair value accounting estimates (highly specialized entity-developed model or no observable inputs)
  - not the amount recognized in the f/s itself >> could be too low...
  - very high estimation uncertainty may be disclosed explicitly in the f/s >> risk of adequacy of disclosures reflecting the applicable financial reporting framework



# Responses to the Assessed Risk of Material Misstatement

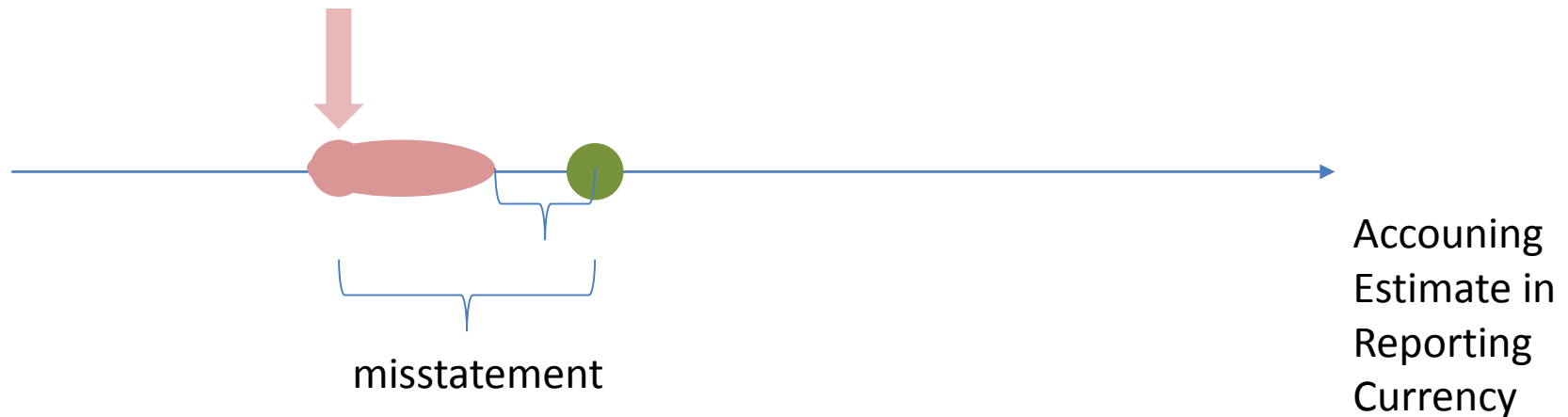
- the auditor shall determine
  - appropriate and consistent application of the relevant methods of the applicable financial reporting framework (and appropriate method-changes, if any)
  - respond to the RMM by one or more of the following:
    - a. whether events occurring up to the date of the auditor's report provide audit evidence
      - SME-consideration: (ISA 540.A67) long period between balance sheet date and auditors report>> review of events in this period may be an effective response (esp. when there are no formal control procedures over accounting estimates)
    - b. test how management made accounting estimate and the data on which it is based (method, assumptions)
      - SME-consideration: (ISA 540.A70) estimation process might be less structured, due to active management involvement / no or less written policies or descriptions; this does not mean, that management is not able to provide a basis for testing accounting estimates by the auditor
    - c. test of controls (operating effectiveness) + substantive procedures
      - SME-consideration: (ISA 540.A86) estimation process might be less structured / formal; no or less controls; that is why substantive audit procedures are performed and one or more responses to the named procedures in a.-d.
    - d. develop a point estimate or a range to evaluate management's point estimate
- the auditor shall consider whether specialized skills or knowledge in relation to aspects of the accounting estimates are required

# Further Substantive Procedures to respond to **Significant Risks**

- minimum requirements in response to significant risks:
  - estimation uncertainty
    - evaluation, how management has considered alternative assumptions or outcomes and why it has rejected them or how management otherwise has addressed estimation uncertainty in making the accounting estimate (smaller entities: simpler means of assessment, inquiry of management, auditor might explain different methods available)
    - whether significant assumptions are reasonable
    - intent of management to carry out specific courses of action and the ability to do so
    - e.g. disposal of an asset, repayment of liabilities etc.
    - if management has not adequately addressed the effects of estimation uncertainty, the auditor, if considered necessary should develop a range with which to evaluate the reasonableness of the accounting estimate
  - recognition and measurement criteria
    - determine, whether those are in accordance with the applicable financial reporting framework

# Evaluating the reasonableness of the accounting estimates and determining misstatements

- basis: audit evidence



- Distinguishment of misstatements:

- factual (no doubt)
- judgemental (auditor considers judgements unreasonable)
- projected (misstatement identified by an audit sample projected to the population)

- auditor's point estimate / range
- management's point estimate

# Disclosures related to accounting estimates

- obtain audit evidence for appropriateness of the disclosures in accordance with requirements of financial reporting framework
  - e.g. assumptions used, method of estimation used, including any applicable model, basis for selection the method, effects of method changes to prior periods
- including adequacy of disclosures regarding estimation uncertainties
  - management might have to disclose (
  - consider implications on auditor's opinion in compliance with ISA 705 (modification, when disclosure is wrong) or 706 (emphasis of matter), where significant risks are involved

# Indicators of possible management bias

- observations during the audit regarding management judgement and decisions: are there indicators for management bias, e.g.
  - selection of estimates that indicate a pattern of optimism or pessimism
  - subjective assessments, that there has been a change of circumstances followed by method changes
  - certain inconsistent assumptions
- indicators do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates

# Written Representations

- from management / where appropriate from those charged with governance, whether they believe significant assumptions used in making accounting estimates are reasonable
- depending on nature, materiality and extent of estimation uncertainty > additional contents of representation: examples given IN ISA 540.A126 and A.127

# Documentation

- includes:
  - generally the requirements of documentation given by ISA 230.8-11
  - additionally:
    - basis for auditor's conclusions about the reasonableness of accounting estimates and their disclosures that give rise to significant risks and
    - indicators of possible management bias, if any



# Outlook

- ISA 540 is being revised by the IFAC
- ED was released in April 2017
- planned finalization and approval of ISA 540 (Revised) March 2018
- Standard is effective for audits of f/s for periods beginning on or after December 15.12.2019 earliest (still to be determined)