

SA 540 "AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES and RELATED DISCLOSURES"

Meaning and Nature of Accounting Estimates

- An Accounting estimate may be defined as “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.
- The degree of estimation uncertainty affects the risks of material misstatement of accounting estimates. [Estimation Uncertainty: The susceptibility of an accounting estimate and related disclosures to an inherent risk of precision in its measurement]
- Degree of estimation uncertainty varies based on:
 - (1) The nature of the accounting estimates
 - (2) The extent to which there is a generally accepted method used to make the accounting estimate.
 - (3) The subjectivity of the assumptions used to make the accounting estimates

Examples of Accounting Estimates

- Allowance for doubtful accounts
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method or asset useful life.
- Provision against the carrying amount of an investment.
- Outcome of long-term contracts.
- Financial Obligations/Costs arising from litigation settlements and judgments

Examples of Fair Value Accounting

- Complex financial instruments.
- Share-based payments.
- Property or equipment held for disposal.
- Certain assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration.
 - (a) **Estimates with low estimation uncertainty**
 - Accounting estimates arising in entities that engage in business activities that are not complex.
 - Accounting estimates that are frequently made and updated because they relate to routine transactions.
 - Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as “observable” in the context of a fair value accounting estimate.
 - Fair value accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement at fair value.

- Fair value accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or inputs to the model are observable.

(b) Estimates with high estimation uncertainty

- Accounting estimates relating to the outcome of litigation.
- Fair value accounting estimates for derivative financial instruments not publicly traded.
- Fair value accounting estimates for which a highly specialised entity developed model is used or for which there are assumptions or inputs that cannot be observed in the market place.

Scope of SA 540

- SA 540 deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of F.S.
- Specifically, it expands on how SA 315 and SA 330 and other relevant SAs are to be applied in relation to accounting estimates.

Objective of Auditor

To obtain sufficient appropriate audit evidence whether:

- Accounting estimates, including fair value accounting estimates are reasonable; and
- Related disclosures in the financial statements are adequate.

Management Bias

- FRF often call for neutrality, that is, freedom from bias. Accounting estimates are imprecise, however, and can be influenced by management judgment. Such judgment may involve unintentional or intentional management bias.
- Susceptibility of an accounting estimate to management bias increases with the subjectivity involved in making it.
- For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.
- Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods.
- Although some form of management bias is inherent in subjective decisions, in making such judgments, there may be no intention by management to mislead the users of F.S. Where, however, there is intention to mislead, management bias is fraudulent in nature.

Risk Assessment Procedures and Related Activities

Auditor shall obtain an understanding of the following in order to identify and assess the risks of material misstatement for accounting estimates:

- (a) The requirements of the applicable financial reporting framework.
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates.

In obtaining this understanding, the auditor shall make **inquiries of management** about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

- (c) The estimation making process adopted by the management including:
- The method, including where applicable the model used in making the accounting estimates;
 - Relevant controls;
 - Where management has used an expert;
 - The assumptions underlying the accounting estimates;
 - Where there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so why; and
 - Whether and if so, how the management has assessed the effect of estimation uncertainty.
- (d) The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.

Inquiries of management about changes in circumstances

Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

Matters that the auditor may consider in obtaining an understanding of the assumptions

Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying the accounting estimates include, for example:

- The nature of the assumptions, including which of the assumptions are likely to be significant assumptions.
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- Where applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- The nature and extent of documentation, if any, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

Review of Outcome of Accounting Estimates

- The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.
- The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements.
- However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at that time.
- The outcome of an accounting estimate will often differ from the accounting estimate recognised in the prior period financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:
 - (1) Information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process.
 - (2) Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
 - (3) Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
- The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

Estimation Uncertainty

- For accounting estimates that give rise to significant risks, the auditor shall evaluate the following:
 - (1) How management has considered alternative assumptions or outcomes, and why it has rejected them.
 - (2) Whether the significant assumptions used by management are reasonable.
 - (3) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
- If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty, the auditor shall, develop a range with which to evaluate the reasonableness of the accounting estimate.

Recognition and Measurement Criteria

For accounting estimates that give rise to significant risks, the auditor shall obtain SAAE whether the following are in accordance with the requirements of the applicable FRF:

- Management's decision to recognise, or to not recognise, the accounting estimates in the F.S.;
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- The selected measurement basis for the accounting estimates.

Identifying and Assessing the Risks of Material Misstatement

- In identifying and assessing the RMM, as required by SA 315, the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate.
- The auditor shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

Factors Influencing Degree of Estimation Uncertainty

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- (1) The extent to which the accounting estimate depends on judgment.
- (2) The sensitivity of the accounting estimate to changes in assumptions.
- (3) The existence of recognised measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- (4) The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
- (5) The availability of reliable data from external sources.
- (6) The extent to which the accounting estimate is based on observable or unobservable inputs.

Responses to Assessed Risks

Based on the assessed risks of material misstatement, the auditor shall determine:

- Whether management has appropriately applied the applicable FRF.
- Whether the methods are appropriate and have been applied consistently.
- Whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

Responses to Significant Risks Estimation Uncertainty

- For accounting estimates that give rise to significant risks, the auditor shall evaluate the following:
 - (1) How management has considered alternative assumptions or outcomes, and why it has rejected them.
 - (2) Whether the significant assumptions used by management are reasonable.
 - (3) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
- If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty, the auditor shall, develop a range with which to evaluate the reasonableness of the accounting estimate.

Measurement and Disclosures Related to Accounting Estimates

- The auditor shall obtain sufficient appropriate audit evidence about whether the accounting estimate and their disclosure in the financial statements is appropriate.
- For accounting estimates that give rise to significant risks, the auditor shall check adequacy of the disclosure of their estimation uncertainty in the financial statements.

Indicators of Possible Management Bias

- The term management bias may be defined as a lack of neutrality by management in the preparation and presentation of information.
- The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.

Indicators of possible management bias

Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.

- Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
- Selection or construction of significant assumptions that yield a point estimate favourable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Written Representations

The auditor shall obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable.

SA 580 "Written Representations" discusses the use of written representations. Depending on the nature, materiality and extent of estimation uncertainty, written representations about accounting estimates recognised or disclosed in the financial statements may include representations:

- About the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable FRF, and the consistency in application of the processes.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosure related to accounting estimates are complete and appropriate under the applicable FRF.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statement