

SA 540 Revised – Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Q. What do you mean by Accounting estimates? How many type of Accounting estimates are involved in preparation of FS?

Some financial statement items cannot be measured precisely, but can only be estimated. According to SA540 (R) "An approximation of a monetary amount in the absence of a precise means of measurement". Usually two kind of estimates are involved in preparing and presenting financial statements:-

1. Fair value Accounting estimates
2. Other Accounting estimates

Fair value accounting estimates means where the measurement objective is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. Every accounting estimate other than Fair value accounting estimate is other estimate. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific.

Q. Illustrate some examples of Fair value estimates and other estimates?

Following are examples of Fair value accounting estimates:-

- Estimate of FMV of Inventory
- Complex financial instruments, which are not traded in an active and open market.
- Share-based payments.
- Property or equipment retired from active use and 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, for example, a non-monetary exchange of plant facilities in different lines of business.

Following are examples of other accounting estimates:-

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

Q. What is objective of auditor in this SA540(R) ?

The objective of the auditor is to obtain sufficient appropriate audit evidence whether in the context of the applicable financial reporting framework:

- (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognised or disclosed, are reasonable; and
- (b) related disclosures in the financial statements are adequate.

Q. What considerations are required by the auditor when performing audit procedures over accounting estimates?

Following steps are involved in audit of accounting estimates

- step -1 Auditor will perform risk assessment procedures and related activities in order to provide a basis for the identification of risk of misstatement

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| step-2 | Auditor's shall give response to assessed risk by determining nature timing and extent of audit procedures. Auditor may apply further substantive procedures to respond to significant risks |
| step-3 | Auditor shall evaluate the reasonableness of the accounting estimates, and determining misstatements |
| step-4 | Auditor shall verify whether proper disclosures related to accounting estimates have been made. |

Q.How auditor will perform risk assessment procedures to assess the risk of misstatement in relation to accounting estimates?

As required by SA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:

- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
- (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements and need to revise existing,accounting estimates.
- (c) How management makes the accounting estimates, and an understanding of the data on which they are based, it includes:
 - (i) The method, including where applicable the model, used in making the accounting estimate;
 - (ii) Relevant controls;
 - (iii) Whether management has used an expert;
 - (iv) The assumptions underlying the accounting estimates;
 - (v) Whether 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
 - (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty.

By applying above procedures auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate and in auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

How auditor shall Responses to the Assessed Risks of Material misstatement in accounting estimates?

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

- Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and
- Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.
- whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate whether:
 - o The method of measurement used is appropriate in the circumstances; and
 - o The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework.
 - o Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.
- Develop a point estimate or a range to evaluate management's point estimate. For this purpose: When the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. When the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.

If required, auditor may apply further substantive procedure to evaluate the accounting estimates involving significant risk.

Q. how auditor will evaluate the reasonableness of the accounting estimates, and determines whether it is misstated?

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. Based on the audit evidence obtained, the auditor may conclude that

1. The evidences of the auditor differ from management's point estimate. In such case if the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.

2. Where management has changed an accounting estimate, or the

method in making it unreasonable :- Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias. How to report misstatement is given in SA450

Q. how auditor will determine that appropriate disclosures related to accounting estimates have been made?

The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

For accounting estimates that give rise to significant risks, the auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.

Q. What are the other considerations required under this sa540?

Consideration as to need for written representations

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

Consideration as to Documentation :-The audit documentation shall include:

- (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
- (b) Indicators of possible management bias, if any.