ISA (Ireland) 540 (Revised December 2018) Auditing Accounting Estimates and Related Disclosures

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The Irish Auditing and Accounting Supervisory Authority (IAASA) have issued ISA (Ireland) 540 (Revised December 2018) Auditing Accounting Estimates and Related Disclosures (ISA 540). In this article we introduce some of the more important changes for audit work arising from the revision of ISA 540.

What is an accounting estimate?

The revised standard defines an accounting estimate as "A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty".

Accounting estimates that an auditor will regularly encounter in the course of his / her work are:

- Calculation of a provision for bad debts.
- Calculation of a provision for losses incurred on long term construction projects.
- Calculation of a provision for warranty costs incurred.
- Estimation of the useful life of an asset to determine an appropriate depreciation / amortisation rate.
- Estimation of the recoverability of financial assets such as loans and certain investments where there are indications that the asset is impaired.
- Calculation of various provisions included in financial statements.

When you calculate an accounting estimate, some degree of estimation uncertainty will always exist, unlike other financial statement figures that are based on a precise calculation. Therefore, accounting for estimates can be subject to a higher risk of material misstatement in financial statements and pose a challenge for the auditor in obtaining sufficient and appropriate audit evidence to support the accuracy of the accounting estimate.

The revised standard introduces enhanced requirements to assist the auditor to respond appropriately to the risk of material misstatements in accounting estimates.

Why was a revised standard required?

Changes to financial reporting standards have increased the importance and visibility of accounting estimates to users of financial statements and consequently the standard required revision. In addition, audit inspection findings had criticised the quality of the audits of accounting estimates and the revised standards set out new requirements that if applied correctly should address many of these audit quality issues.

It is important to acknowledge that financial statements of relatively simple and straightforward businesses can still include significant accounting estimates. Accounting for long term construction contracts, calculating provisions for stock losses and calculating recoverable amount of assets can involve the making of material accounting estimates that can be subject to a high risk of material misstatement. Auditors of small and medium sized companies should not dismiss the revised standard as being only relevant to the auditors of large companies.

The new requirements are designed to be "scalable". Therefore, where there are limited accounting estimates in financial statements, the impact of the revised standard will not be significant. In financial statements that include significant and complex accounting estimates, the new requirements will require significant changes by the auditor in the audit approach adopted to the audit of these estimates.

Effective date

The revised standard is effective for audits of financial statements for periods beginning on or after December 15th, 2019. Early adoption is permitted.

Objective in the revised standard

The objective of the auditor as set out in the standard is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.

Some requirements of ISA 540

The standard is detailed and complex in its content and it is not possible to comprehensibly address all the requirements of the standard in a short article. We set out below some of the more important requirements in ISA 540.

- There is increased emphasis on the need for the risk assessments in this area to be informed by the auditors' understanding of the entity, its environment and internal control. When obtaining an understanding of the entity and its environment, including the entity's internal control, the auditor must obtain an understanding of the stated matters related to the entity's accounting estimates as set down in the revised standard.

- Enhanced audit risk assessment procedures are required in relation to accounting estimates. The auditor is now required to separately assess inherent risk and control risk in identifying the risks of material misstatement in accounting estimates. In assessing inherent risk, the auditor must have regard to

a. The degree to which the accounting estimate is subject to estimation uncertainty; and

b. The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors:

   i. The selection and application of the method, assumptions, and data in making the accounting estimate; or

   ii. The selection of management's point estimate and related disclosures for inclusion in the financial statements.

If any of the risks of material misstatement identified are, in the auditor's judgment, a significant audit risk, the auditor must obtain an understanding of the entity's controls, including control activities, relevant to that risk.

- The revised standard includes the concept of the spectrum of inherent risk. The assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement in the accounting estimate and varies on a scale that is referred to in the revised ISA 540 (Ireland) as the spectrum of inherent risk. The higher on the spectrum the audit risk falls, the more persuasive the audit evidence needs to be to allow the auditor to form an audit conclusion in relation to the estimate.

- Based on the results of the risk assessment, the revised ISA states that the auditor's further audit procedures will be responsive to the assessed risks of material misstatement at the assertion level considering the reasons for the assessment given to those risks. The auditor's further audit procedures will include one or more of the following approaches:

a. Obtaining audit evidence from events occurring up to the date of the auditor's report.

b. Testing how management made the accounting estimate; or

c. Developing an auditor's point estimate or range.

d. The standard contains detailed guidance on the development of the appropriate audit response to the assessed audit risk and the auditor should become familiar with this guidance.

- The auditor must design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate. Disclosure in relation to accounting estimates can provide useful information to the user of the financial statements and hence the importance of these disclosures not containing material misstatements.

- Auditors must be alert to indicators of possible management bias and respond appropriately where such indicators exist. Management bias could be present because of the desire of management to present a certain predefined outcome in the financial statements. Management bias could be conscious or unconscious on the part of management.

- The auditor must evaluate, based on the audit procedures performed and audit evidence obtained, whether:

a. The assessment of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified.

b. Management's decisions relating to the recognition, measurement, presentation, and disclosure of accounting estimates in the financial statements are in accordance with the applicable financial reporting framework; and

c. Sufficient appropriate audit evidence has been obtained.

These requirements call for the auditor to have a good knowledge of the measurement and disclosure rules set down in the chosen financial framework in relation to the matters giving rise to the accounting estimate. Company law may also provide rules in relation to accounting estimates.

- Written representations from management and, when appropriate, those charged with governance should be obtained in relation to:
  - whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition,

measurement or disclosure that is in accordance with the applicable financial reporting framework.

- specific accounting estimates, including in relation to the methods, assumptions, or data used where appropriate.

- Auditors are required to review and document the outcome of previous accounting estimates. This allows the auditor to assess how accurate management were in the past in making accounting estimates. The results of this work will feed into the current year audit risk assessment in relation to material misstatement in the current year accounting estimates.
- The revised standard introduces and formalises the idea of 'inherent risk factors.' Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement before consideration of controls. Appendix 1 of the revised standard explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.
- The standard introduces new material to enhance professional scepticism of the auditor.
- The revised ISA introduces enhanced documentation requirements that the auditor must meet.

Some steps to take to assist in applying the new requirements of the standard

The following practical steps will assist in ensuring that the quality of audit work undertaken follows the requirements of the revised standard.

1. Audit staff need to be made aware of the requirements of the revised standard and the implications for the audit of financial statements for periods beginning on or after 15 December 2019.
2. Auditors should take steps to ensure that the auditor's understanding of the entity and its environment is amended to take account of the revised requirements as set down in ISA 540.
3. When planning audit assignments, the audit staff should identify financial statements that contain material accounting estimates and ensure that staff with the appropriate knowledge and experience are assigned to such audit assignments.
4. The Auditor should confirm that standard audit programmes used in audit assignment were updated to reflect the revised requirements of ISA (Ireland) 540.
5. The auditor and audit team members must maintain professional scepticism throughout the audit assignment.
6. 6. The Auditor and audit team members should be alert to management bias in arriving at accounting estimates.
7. The standard of documentation in relation to accounting estimates should be reviewed to ensure it is adequate in light of the revised requirements of ISA (Ireland) 540.
8. Finally, remember to obtain suitable written management representations in relation to accounting estimates.

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