ADAA ISA 540 briefing paper

Auditing Accounting Estimates by Steven Ralls

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Background

In December 2015 the IAASB released its Invitation to Comment (ITC) 'Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control, and Group Audits'. This highlighted the Board's discussions on these topics and flagged potential standard-setting activities the IAASB would take to enhance audit quality. 87 comment letters were received (link) and so the IAASB has been working through changes to standards. The first of which is the revised ISA 540 effective for audits of accounting periods beginning on or after 15 December 2019. The old standard ran to 44 pages; the new to 94, and is accompanied by 32 pages of 'Basis for Conclusions' so even though the audit of accounting estimates is as old as the audit profession itself, there must be quite a difference.

Why a revised ISA 540?

There are several reasons:

- New IFRS 9, effective 2018, moves banks from estimating provisions on an incurred loss model, to estimating provisions on an expected loss model. The expected loss models are naturally more complex. Therefore, there is a greater inherent risk that the model breaks down. They require significantly more assumptions to be considered, including judgements on the likely default point for different customers, at different points of the economic cycle.

- Several respondents to the ITC thought that many of the IAASB's suggested improvements appeared to relate to additional application material, which would not lead to sufficient change in auditor behaviour. Respondents encouraged the IAASB to focus on enhancing standards either through clarification of requirements or new requirements, to support the principles in the standards.

- Regulatory bodies such as IFIAR and EFAA reported a strong correlation between poor understanding and application of ISA 540 and the finding of audit deficiencies.

Audit areas affected

- Inventory obsolescence provisions. IAS 2 requires measurement at historic cost or net realisable value if lower. This fits well with an expected loss model. Obsolescence is normally a binary decision. Therefore, if your provisioning is based on 30% after 6 months, 75% after 9 months and 100% at one year, then your model needs to change to reflect when the loss became expected.
- Assessment of useful life and residual value in estimating initial, and extended use for estimating depreciation of property, plant and equipment.
- Valuation of infrastructure assets. Normally a discounted cash flow model on a value in use (VIU) basis is prepared. If numbers are not contractually fixed there can be variations in growth rates, revenue/cost changes, discount rates. Sometimes these can be market tested, sometimes not. Now there are additional audit tests when not.
- Valuation of financial instruments. Not the level one and two ones!
- Outcome of pending litigation.
- Provision for expected credit losses.
- Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets.
- Warranty obligations. Estimating these is a bit of a dark art, as is estimating insured, but not received, insurance claims. Warranty claims also don't fit with an incurred loss model, because how do you know when the product became deficient and the loss incurred? During manufacture, distribution, or use?

There is a full list of audit areas affected in the application guidance (ISA 540.A1).

The key concepts of revised ISA 540

Risk assessment

This section of the standard has been substantially changed and enhanced. ISA 540 still focuses on the risk of an accounting misstatement at the audit assertion level. However, risk assessment is now split between inherent risk and control risk. The nature and detail of the words describing risk assessment is increased.

Inherent risks include complexity, subjectivity, estimation uncertainty and others:

- The entity's transactions and other events that may give rise to the need for, or changes in, accounting estimates.
- The requirements of the applicable financial reporting framework (including recognition criteria, measurement bases, presentation and disclosure) and how they apply in the context of the nature or circumstances of the entity and its environment and subject to, or affected by inherent risk.
- Regulatory factors, including when related to prudential supervision.
- The nature of the accounting estimate and related disclosures.

Control risks primarily relate to:

- The nature and extent of oversight and governance relevant to estimates.
- How management identify the need for, and applies, specialized skills.
- How the risk assessment process identifies and addresses risks.
- Information systems as they relate to accounting estimates, including:
  - Classes of transactions, events and conditions that give rise to the need to change an estimate,
  - For such, how management:
    - Identifies the relevant methods, assumptions or sources of data. Including selection design and application of methods used, assumptions and alternatives and data to be used.
- Control activities relevant to audit over management's process as described in the first four bullets.
- How management reviews the outcomes of previous accounting estimates and responds to the results of that review.

The revised ISA 540.5 emphasises the importance of the auditor's decisions about controls relating to accounting estimates by highlighting relevant requirements in ISA 315 and ISA 330, and providing related guidance, including decisions about whether:

- *There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented,*
- *To test the operating effectiveness of relevant controls."*

A key area for consideration will be governance controls.

Scalable

ISA 540 applies equally to straightforward and less than straightforward accounting estimates. The differentiator in such situations is the assessed risk of material misstatement. The more likely the risk of misstatement the more persuasive the audit evidence required.

Professional scepticism

In the 21st century, transactions can be more complex than they were previously, the world is a more litigious place, liabilities that did not exist now do. This requires fresh thinking. It requires more sceptical behaviour. (Is there such a thing as more sceptical behaviour or only sceptical behaviour and not sceptical behaviour?) Scepticism is binary, it is not scalable. Auditors are either sceptical or not. The key question as ever is how much evidence is enough?

Old ISA 540.23 required *"documentation of:*

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."

Revised ISA 540.39 goes further and requires *"in the audit documentation:*

a) Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the accounting estimates.

b) The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks.

c) The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty

d) Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit.

e) Significant judgements relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable reporting framework, or are misstated."

Reasonableness of accounting estimates and disclosures

The objective of old ISA 540 was to obtain sufficient appropriate audit evidence that the accounting estimate is reasonable and the related disclosures adequate. The revised ISA 540 objective is to obtain sufficient appropriate audit evidence that both the accounting estimate and the related disclosures are reasonable. This is a significant change, particularly in relation to estimation uncertainty. ISA 540.27 requires that: *"When, in the auditor's judgement…management has not taken appropriate steps to understand or address estimation uncertainty"* the auditor must get management to do so. And if they don't then the auditor must do it and evaluate whether a deficiency in internal control exists in accordance with ISA 265.

Relevant disclosures have always been important in financial reporting. The worry (fairly held) that too much disclosure might enable a competitor to gain knowledge has to be balanced against insufficient disclosure resulting in wrong decision making by investors and creditors.

Management experts

Old ISA 540.8 simply referred to if management had used an expert and provided four examples of when this was likely (A29/A30). Revised ISA 540.30 is more detailed. Reference is made to ISA 500.8(c) to *"Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion"* and the application guidance (A126/A130) is vastly more detailed than old ISA 540. Revised ISA 540 makes the specific point (A130) that *"Assumptions…made or identified by a management's expert become management's assumptions…Accordingly, the auditor applies the relevant requirements in this ISA to those assumptions."* So in practice, if a third party valuation expert is contracted to value an asset, a risk assessment must be applied to assess the risk the valuation expert is wrong. It is not enough to say they have the relevant qualification.

Revised ISA 540 makes special reference to procedures for the valuation of financial assets and what the auditor must do when there are divergent market views from experts about valuations of assets and liabilities. This significantly increases reliance on applying relevant audit procedures in emerging markets compared to mature markets.

Communication with those charged with governance

Revised ISA 540.38 makes specific reference to ISA 260 and ISA 265 which requires the auditor to communicate significant qualitative aspects of the entities accounting practices and significant deficiencies in internal control. In doing so, the auditor considers the matters regarding accounting estimates including the risks of material misstatement relating to estimation uncertainty, complexity, subjectivity or other inherent risk factors.

Written representations

Old ISA 540 required the auditor to obtain written representation that the significant assumptions used in making accounting estimates are reasonable. Revised ISA 540 requires written representation that *"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."*

The language used by the IAASB is much tighter and much more specific in relation to the audit evidence determining the accounting and disclosure. This is no longer a reasonableness test.

Final thought

Old ISA 540 had a requirement for the auditor to *"review the judgements and decisions made by management in the making of accounting estimates to identify whether that are indicators of possible management bias."*

Revised ISA 540 requires that an assessment of management bias is made for judgements in selecting the model, assumptions and/or data. Paragraph 32 requires that auditors consider bias in judgements made by management in making accounting estimates in the financial statements, even if they are individually reasonable.

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