Nexia SAB&T
Training and Technical

An overview of Accounting Estimates (ISA 540)

November 2019

The revised standard on Auditing Accounting Estimates has enhanced auditors' responsibilities when auditing accounting estimates and its related disclosures.

The revised ISA 540 applies to all audits for periods beginning on or after 15 December 2019.

With financial reporting frameworks requiring more complex accounting estimates with high estimation uncertainty, auditors have increased responsibility when it comes to the auditing of these estimates and its related disclosures in the financial statements.

1. Main components of an estimation process

The 3 main components in the process when determining accounting estimates are:

Methods & models	prescribed/alternative/self-developed/licensed/acceptable industry methods/consistency/complexity/subjectivity
Assumptions	significance/consistency/complexity/subjectivity
Data	nature/source/volume/relevance/reliability/accuracy/completeness/ consistency/integrity during processing/complexity/subjectivity

2. Auditor's responsibilities when auditing accounting estimates

The key changes in the audit process around accounting estimates and the possible impact on management are indicated in the table below:

Audit process	Impact on Management
Professional skepticism	Auditors challenge aspects on how management derive at accounting estimates
Assessment of risk that accounting estimates are materially misstated	Auditors place more emphasis on obtaining understanding of nature and extent of the estimation process and key aspects of related policies and procedures
Response to levels of estimation uncertainty, complexity and subjectivity in accounting estimates	Where risk of estimate being materially misstated is higher, it will require more audit work effort, requiring more information to be provided to the auditor.
Obtaining understanding of significant matters considered by management in making judgments and decisions and auditing of management's selected approaches	More focused audit requests on each matter. Consider retaining experts to assist with related work. Documentation of key judgements and decision made during estimation process.
More emphasis on auditing disclosures of estimates in financial statements	Where risk of estimate being materially misstated is higher, it will require more audit work effort, requiring more information to be provided to the auditor.
Written representations	Requests for new/changed management representations compared to previous years

Management should expect the following questions to be asked by auditors about the estimation process:

- What are your control processes around accounting estimates?
- How are relevant significant transactions, conditions or events communicated to the person(s) responsible for making the accounting estimate(s)?
- Do you review the outcome(s) of previous accounting estimates and how do you respond to the results of the review?
- How is compliance with your financial reporting framework requirements regarding accounting estimates achieved?
- How are regulatory factors relevant to the accounting estimates accounted for?
- How is the need for specialized skills, including the use of a management expert, identified and applied?
- What is your risk assessment process to identify and address risks relating to accounting estimates?
- How do you identify the relevant methods/models, assumptions and data in the estimation process? How do you determine the need for changes in them?
- How to you address the degree of estimation uncertainty in selecting your final point estimates?
- How do you describe these processes for deriving your accounting estimates and degrees of estimation uncertainty in the financial statements (disclosures)?
- Is there oversight and governance in place over the financial reporting process of accounting estimates?

3. Management responsibilities in determining when accounting estimates are needed

Determining whether accounting estimates are needed require proper processes and controls to identify any transactions, events or conditions that give rise to such estimates. The need for accounting estimates will depend on the nature of the entity, the environment, transactions entered into and other events, conditions or circumstances. Management would need to think about (1) transactions that require accounting estimates or changes to them and (2) conditions/events that may require accounting estimates or changes to them.