

Audit Client Briefing
November 2019



**Considerations for Management
When Determining Accounting
Estimates and Related
Disclosures**

IAASB

**International Auditing
and Assurance
Standards Board**

About the IAASB

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related services standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

Acknowledgement

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Purpose of This *Briefing*

The IAASB recently completed a significant revision for its standard for auditing accounting estimates. These revisions may have important implications for chief financial officers, other senior management responsible for financial statement preparation, and staff directly involved in determining whether accounting estimates are needed and, if so, deriving the monetary amounts (recorded or disclosed) of those accounting estimates. Moreover, while not aimed at the audit committee, this *Briefing* may also be a useful resource for its members.

The purpose of this *Briefing* is to make you aware of matters to consider in preparing for and responding to the significant revisions in, and the auditor's requests pertaining to International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*.

ISA 540 (Revised) applies to audits of all accounting estimates in financial statements for periods beginning on or after December 15, 2019. This revised ISA responds to changes to financial reporting standards and a more complex business environment which together have increased the importance of accounting estimates to the users of financial statements and introduced new challenges for preparers and auditors.

Accounting estimates are monetary amounts that are a fundamental part of the financial statements of many entities. Once the need for an accounting estimate is recognized, the measurement of these monetary amounts is subject to estimation uncertainty because of inherent limitations in knowledge or data. As a result, there may be a wide range of measurement outcomes. Your process and controls for deriving the monetary amounts of accounting estimates involve selecting and applying methods (including models) using assumptions and data. This requires you to exercise judgment and may involve complexity and subjectivity (including possible bias) in your measurements. These factors make your accounting estimates susceptible to material misstatement.

In many cases, there will be changes in the nature and extent of information auditors request you provide regarding your process and controls for:

- identifying the need for accounting estimates
- deriving the monetary amounts for accounting estimates and related disclosures.

This *Briefing* provides an overview of:

- management's responsibilities in determining when accounting estimates are needed
- management's responsibilities regarding the main components of an estimation process
- the impact on management because of changes to the auditor's responsibilities, including broad questions auditors are likely to ask those involved in the detailed aspects of your estimation process.

Identifying the Need for Accounting Estimates

Many financial reporting frameworks state that, as a result of the uncertainties inherent in business activities, many items in financial statements cannot be measured with precision; these can only be estimated. Estimation involves judgments based on information that is both the latest available and reliable. Moreover, financial reporting frameworks are evolving, with greater use of complex accounting estimates, whether based on fair value measurements or otherwise, some of which require significant management judgment or involve complexity in the face of high levels of estimation uncertainty.

The determination of whether accounting estimates are needed necessitates proper processes and controls to identify the transactions, conditions or events that give rise to such estimates. The lack of these processes and controls may affect the susceptibility of your financial statements to material misstatement.

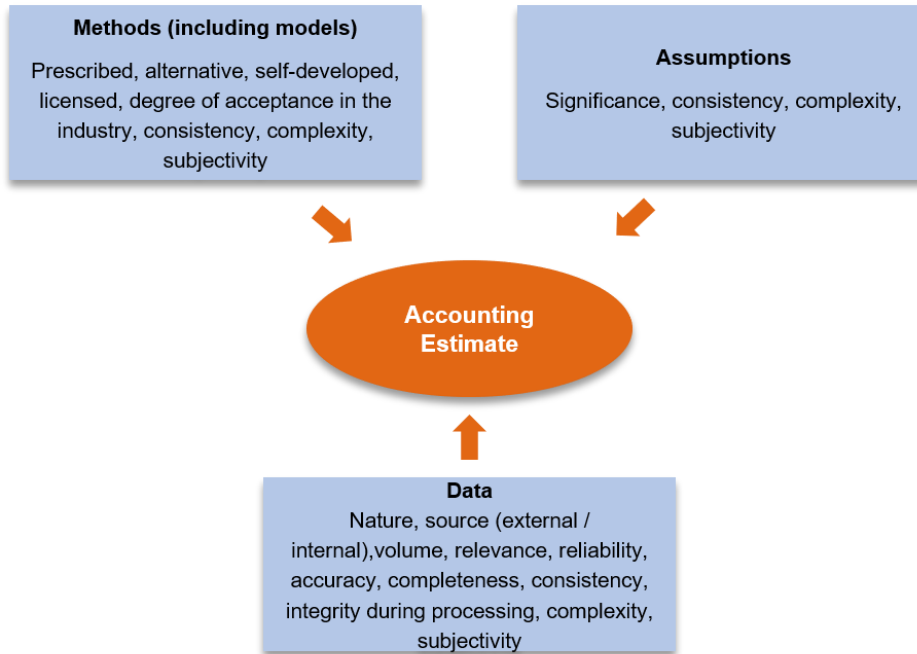
The types of accounting estimates you need to make in accordance with the requirements of the applicable financial reporting framework, depend, for example, on the nature of your entity, the environment in which it operates, the transactions you enter into and the occurrence of other events, conditions and circumstances. In each new financial reporting period, changes may occur (e.g., new types of contracts entered into) that result in a need for you to make accounting estimates that were not required in the previous period. In some cases, you may determine that the types of accounting estimates to be made in the current period are the same as in previous periods. However, you may want or need to make changes in how those accounting estimates are made. For example, you would take into account the benefit gained from previous experience or the need to reflect new information that is now available.

Accordingly, you will need to think about:

- transactions that require accounting estimates or changes to them
- conditions or events that require accounting estimates or changes to them.

Main Components of the Process to Derive the Monetary Amounts of Accounting Estimates

Figure 1 – Inputs to Accounting



There are three main components of the process for determining accounting estimates and related disclosures:

1. methods (including models)
2. assumptions
3. data.

As noted in Figure 1, these components or inputs to the process have a number of characteristics, and they all impact the determination of the accounting estimate. For example, assumptions may vary with sources of the data and the basis of your judgments to support them. Also, a method is applied using a model (computational tool or process) and involves applying assumptions and data and taking into account a set of relationships among them.

The revised audit requirements apply to all accounting estimates. It is important to note that the more complex the estimate, the more the auditor will expect you to have a robust process in place. Some accounting estimates may be simple because they have lower levels of estimation uncertainty and do not require a complex method/model. Therefore, the audit work effort required under ISA 540 (Revised) will not necessarily always be extensive.

Impact on Management of Changes to the Auditor’s Responsibilities

Set out below are some key changes to ISA 540 (Revised) and how these may affect the nature and extent of information the auditor may request.

Key Change	Impact on Auditor	Impact on Management
<i>More emphasis on the need for the auditor to exercise professional skepticism</i>	The auditor will perform audit procedures in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory. The auditor will carefully consider all information obtained and whether it corroborates or contradicts your judgments and decisions regarding accounting estimates.	The auditor may increasingly challenge aspects of how you derive your accounting estimates.
<i>More granular assessments regarding the risk accounting estimates are materially misstated</i>	The auditor will first consider the conditions and events that are likely to cause your accounting estimates to be materially misstated. The auditor will then consider whether the system of internal control you have designed and implemented is likely to prevent material misstatements, or if a material misstatement occurs, is likely to detect and correct it.	The auditor may place more emphasis on obtaining an understanding of the nature and extent of your estimation process and key aspects of the related policies and procedures.
<i>Focus on appropriately responding to the levels of estimation uncertainty, complexity and subjectivity in accounting estimates</i>	The extent of the auditor's required work effort depends on the risk your accounting estimate is materially misstated. This risk is impacted by the degree of estimation uncertainty, complexity, and subjectivity involved in making that accounting estimate.	If the auditor determines the risk of your accounting estimate being materially misstated is higher, the work effort will increase, which in turn will likely impact how much, and the type of, information you need to provide the auditor.
<i>Audit work effort based on the selected approach(es) (testing management's process, developing own estimate, subsequent events), including a more detailed understanding of the significant matters considered in making key judgments and decisions affecting accounting estimates</i>	ISA 540 (Revised) includes revised audit requirements that are more specifically directed at the components of an accounting estimate. These include methods (including models), assumptions and data, including the auditor's understanding and documentation of key elements of the entity and its environment, the linkage of audit procedures to the assessed risks, and significant judgments related to the auditor's determination of whether the accounting estimates and related disclosures are reasonable.	You may receive more focused requests from the auditor on each of these matters. You may wish to consider retaining experts to assist with the related work. You may also consider documenting key judgments and decisions in anticipation of auditor requests. Such documentation is likely to provide a basis for more efficient and effective discussions between you and the auditor.

Key Change	Impact on Auditor	Impact on Management
<i>More emphasis on auditing accounting estimate disclosures in the financial statements</i>	In particular, the sufficiency of disclosures regarding estimation uncertainty may receive more scrutiny.	If the auditor determines the risk of material misstatement is higher for certain disclosures, the work effort will increase, which in turn will impact how much, and the type of, information you will need to provide the auditor.
<i>More detailed written representations</i>	<p>The auditor is required to request written representations from you regarding the reasonableness of the methods, significant assumptions and the data used in determining the monetary amounts of accounting estimates, including the related disclosures, in accordance with the applicable financial reporting framework.</p> <p>The auditor is also required to consider the need to obtain your representations about specific accounting estimates, including in relation to the methods, assumptions, or data used.</p>	<p>You may receive requests for new or changed representations compared to previous years. Therefore, you may wish to ask the auditor to let you know as soon as practicable the details of the written representations they will request from you.</p>

A more detailed overview of the key changes can be found at [IAASB "At a Glance"](#).

Broad Questions Auditors Are Likely to Ask about Your Estimation Process

Figure 2 sets out broad questions the auditor is likely to ask to obtain or confirm understanding of, and whether there have been changes to, key aspects of your process for deriving accounting estimates.

How do you...



- control your accounting estimation process?
- make those responsible for deriving or changing your accounting estimates aware of relevant significant transactions, conditions or events?
- review the outcome(s) of previous accounting estimates and respond to the results of that review?
- identify and comply with the relevant requirements in the applicable financial reporting framework regarding your accounting estimates and related disclosures including how they are affected by complexity and your judgment?
- account for regulatory factors relevant to the entity's accounting estimates, including, when applicable, regulatory frameworks related to prudential supervision?
- identify the need for, and apply, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert?
- identify and address risks related to accounting estimates through your risk assessment process?
- identify relevant methods (including models). Assumptions and data and the need for changes in them and from those identified, select those to apply?
- address the degree of estimation uncertainty in selecting your final point estimates?
- describe in your financial statements matters related to your process for deriving your accounting estimates, and matters related to the degrees of estimation uncertainty underlying your accounting estimates?
- ensure there is oversight and governance in place over management's financial reporting process relevant to accounting estimates?

The broad questions auditors are likely to ask, as set out in the shaded box above, relate to what are likely to be the main steps of your accounting estimation process.

The first question in Figure 2 “How do you control your accounting estimation process?” applies to all aspects of your accounting estimation process. This includes not only how you designed and implemented your process, but also the policies and procedures you put in place to satisfy yourself that each step in your process is properly applied, and that the resulting accounting estimates are reasonable in the context of the applicable financial reporting framework.

Call to Action

Your company’s auditor will expect you to have designed, performed and appropriately documented the accounting estimation process. As a result of the changes to the audit, you may see a need and an opportunity to improve the quality of your process for deriving accounting estimates and related disclosures. Your consideration of the matters raised in this *Briefing* may help you achieve that objective.

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