

2020

Audit Quality Unit

The audit of accounting estimates

About IAASA

The Irish Auditing and Accounting Supervisory Authority ('IAASA' or 'the Authority') is designated as the competent authority in Ireland responsible for quality assurance reviews of statutory auditors and audit firms that carry out statutory audits of public-interest entities (audits of PIEs).

The Authority accepts no liability and disclaims all responsibility for the consequences of anyone acting or refraining from acting in reliance on the information contained in this document or for any decision based on it.

Mission

To contribute to Ireland having a strong regulatory environment in which to do business by supervising and promoting high quality financial reporting, auditing and effective regulation of the accounting profession in the public interest.

Introduction

Recent developments in international financial reporting standards and in international auditing standards reflect the increased focus on audit quality in the area of accounting estimates. Accounting estimates are those financial statement items that cannot be measured precisely and the nature and reliability of the information supporting an accounting estimate can vary.

Accounting estimates present in many forms across all types of industries. Accounting estimates can be complex and often reflect judgements made by an entity's management. To address the judgements and complexities, local and international financial reporting frameworks have specific requirements for accounting estimates, such as disclosures around assumptions and sources of estimation uncertainty.

The International Standard on Auditing (Ireland) 540, Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures, has been revised with effect for audits of financial statements for periods beginning on or after 15 December 2019 (ISA 540 (revised)).

Purpose of this paper

This paper explains the requirements of previous and incoming auditing standards that deal with accounting estimates. The paper gives insight into European and International audit regulators' views on the quality of audit work around accounting estimates and discusses IAASA's observations. The paper also sets out IAASA's expectations of auditors in this area going forward.

Auditing standards

ISA 540

The International Standard on Auditing (Ireland) 540, Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures, (ISA 540) sets out the specific requirements for auditing accounting estimates, including fair value accounting estimates, and related disclosures.

ISA 540 sets out the required risk assessment procedures, which include understanding how management make an accounting estimate. Auditors must evaluate the degree of uncertainty associated with an accounting estimate and determine whether a high level of estimation uncertainty gives rise to a significant risk. Based on this risk assessment, auditors are required to determine whether the methods for making the accounting estimate were appropriate and to perform certain procedures, taking into account the nature of the accounting estimate. Where significant risks have been identified, further procedures are required to evaluate the reasonableness of assumptions and alternative assumptions or outcomes. Auditors must also review the judgements and decisions made to identify whether there are indicators of possible management bias. The adequacy of disclosures around accounting estimates must also be evaluated.

ISA 540 was written before recent changes in international financial reporting standards, such as new requirements to account for expected credit losses and revised standards dealing with insurance contracts, revenue recognition and leases. These financial reporting changes, along with recurring audit inspection findings on the quality of the audit of accounting estimates has led to a revision of the auditing standard in this area. ISA 540 has been revised with effect for audits of financial statements

for periods beginning on or after 15 December 2019 (ISA 540 (revised)). Auditing regulators expect to begin reviewing auditors' application of the revised standard in the latter part of 2021.

ISA 540 (revised)

ISA 540 (revised) establishes more robust requirements to drive auditors to perform appropriate procedures in relation to accounting estimates and related disclosures, and emphasises the importance of the appropriate application of professional scepticism when auditing accounting estimates.

The revised standard uses stronger language to reinforce the importance of exercising professional scepticism. The standard addresses a spectrum of inherent risk associated with accounting estimates, introducing the concept of inherent risk factors beyond estimation uncertainty, such as complexity and subjectivity. In applying ISA 540 (revised), auditors must perform enhanced risk assessment procedures to understand the entity, its environment and its internal control and separate out the assessment of inherent and control risk. The revised standard introduces an objectives-based work effort requirements directed to methods, data and assumptions. Further audit procedures need to be responsive to the reasons for the assessed risks at the assertion level. Building on the previous standard, ISA 540 (revised) enhances the "stand back" requirement. Auditors are required to evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence. Along with the revised standard, there is new and enhanced application material for auditors. The application material demonstrates how the revised standard can be scaled up or down, depending on the nature and complexity of the accounting estimates. The standard also explicitly cross-refers to the requirements of other relevant auditing standards such as the need to test controls for significant risks in the current period and the use of management's experts.

Regulatory findings on the audit of accounting estimates

The Committee of European Auditing Oversight Bodies (CEAOB) and the International Forum of Independent Audit Regulators (IFIAR) provide platforms for audit regulators to report and discuss findings in relation to audit quality.

Findings reported to IFIAR¹

In 2019, 42 audit regulators across the Americas, Asia Pacific, Europe and Middle East and Africa reported findings to IFIAR.

Accounting estimates, including fair value measurement was the area with the **highest frequency of inspection findings** for listed public-interest entity audits in each year between 2016 and 2019.

Over **22%** of all findings reported by 42 IFIAR members relating to listed PIE audits in 2019 were in this area. The topic was inspected in 614 listed PIE audits with audit regulators reporting at least one finding in the area for 138 audits.

In 2018, 2017 and 2016, 28%, 29% and 32% of findings reported were in relation to accounting estimates, including fair value measurement.

¹ The IFIAR 2019 survey of inspection findings is available at: <https://www.ifiar.org/?wpdmdl=10453>

Examples of findings by IFIAR members relating to accounting estimates:

- reasonableness of assumptions - when testing an accounting estimate, failure to assess the reasonableness of assumptions including consideration of contrary or inconsistent evidence where applicable
- failure to sufficiently test the accuracy of the data
- failure to perform sufficient risk assessment procedures
- failure to adequately consider indicators of bias
- failure to evaluate how management considered alternative assumptions
- failure to take relevant variables into account
- insufficient challenge and testing of management's judgments and assessments

Findings reported to the CEAOB²

The CEAOB have also noted that there are findings relating to the audit quality of accounting estimates across four key industries for public interest entities.

Inspection findings reported to the CEAOB between 2014 and 2019 showed that findings in relation to the application of ISA 540 represented:

- **14%** of findings within the **banking industry**
- **13%** of findings within the **industrial products industry**
- **11%** of findings within the **retail and consumer products industry**
- **11%** of findings within the **insurance industry**

Examples of **banking industry** findings by CEAOB members relating to accounting estimates:

- placing reliance on cash flow forecasts prepared by management for impairment on specific individual loans without challenging or performing sufficient audit procedures to test these key assumptions and conclusions
- failure to perform appropriate audit procedures on portfolio loan loss provision
- no audit evidence regarding completeness, accuracy and valuation of significant financial assets
- the failure to challenge the significant variance between two valuations provided for the same asset

Examples of **retail and consumer products industry** findings by CEAOB members relating to accounting estimates included insufficient challenge of management's key assumptions and valuation methods (e.g., gross valuation and provision on inventory, trademark, store's impairment).

² The information on findings reported to the CEAOB was published by the CEAOB in the appendices to the 7th meeting of the CEAOB inspections sub-group in November 2019, see https://ec.europa.eu/info/business-economy-euro/banking-and-finance/regulatory-process-financial-services/expert-groups-comitology-and-other-committees/committee-european-auditing-oversight-bodies_en#subgroups

Examples of **industrial products industry** findings by CEAOB members relating to accounting estimates included insufficient challenging of management's key assumptions and valuation methods.

Examples of **insurance industry** findings by CEAOB members relating to accounting estimates included:

- issues with audit quality around data integrity, completeness and accuracy for reserving purposes when responsibility is shared between auditor and actuaries
- insufficient evidence of review of an auditor's expert's work
- failure to justify the basis for not assessing outstanding claims and incurred but not reported reserves as significant risks

IAASA's observations on the audit of accounting estimates

IAASA's inspection methodology

In line with European counterparts, IAASA uses a common audit inspection methodology (CAIM) to inspect the audit work performed in relation to accounting estimates. The CAIM inspection procedures focus on three areas: risk assessment, responses to the assessed risks of material misstatement, and auditor's report and disclosures related to accounting estimates.

Case study: what does “good practice” in auditing accounting estimates look like?

Through the inspection of auditors' work in relation to accounting estimates, IAASA has identified many examples of good practice. The below case study illustrates the application of good practice in the area.

Case study background

In this case study, technical specialists in the company developed an accounting estimate through the application of recognised industry techniques. The accounting estimate was developed using system based models that processed information based on the company's historical experience along with assumptions applied by the company's technical specialists.

How did the auditor assess the risk of material misstatement?

A significant risk, including the risk of fraud, was assigned to the valuation of the accounting estimate. The auditor noted that the accounting estimate was non-routine, complex and involved judgment. The auditor performed further procedures, such as analysing historic developments, assessing the techniques applied by the technical specialists and assessing the nature of each component of the accounting estimate and pinpointed the risk to apply to specific components of the accounting estimate. Throughout the audit engagement, the auditor evidenced their consideration of new information and its impact on their risk assessment.

How did the auditor respond to the significant risk associated with the accounting estimate?

Evaluation of controls

The auditor evaluated the design effectiveness and implementation of controls throughout the end-to-end process and covered the data, assumptions, methodology and results. The auditor evaluated the operating effectiveness of several controls to supplement their substantive procedures.

Re-projection of the accounting estimate

The auditor engaged a technical specialist to perform an independent re-projection of the accounting estimate. As part of the re-projection exercise, the technical specialists reviewed and challenged judgements applied by the company in developing the accounting estimate. The audit documentation evidences detailed discussions with the company's technical specialists to understand the development of the accounting estimate and evidenced procedures to corroborate and challenge this information, such as the cross checking of certain judgements made to market benchmarks. In re-projecting the accounting estimate, the auditor's technical specialist also flexed their own assumptions. The results of the re-projection exercise showed that, overall, the company's accounting estimate was within the auditor's range of best estimates.

Evaluation of the integrity of the data used

Controls were evaluated around the segmentation of data and the reconciliation of data between systems, including between the system outputs and the general ledger. Checks were performed to ensure that the data used by the auditor's expert matched the data extracted from the company's system and the parameters applied in the extraction of these data were checked. Checks were also made to ensure that no adjustments were made to the data. Substantive attribute testing was performed to verify the integrity of data between systems and the general ledger. Substantive tests were also performed to verify the accuracy of the data input to the initial source system.

Retrospective review

The auditor performed a retrospective review, evaluating the largest changes in the accounting estimate from the prior year. Further to this, quarterly reports showing the development of the accounting estimate were analysed by the auditor's expert.

What demonstrated “**good practice**” in this case study?

- Continuous and pinpointed risk assessment
- Clear application of the requirements of ISA 540 and of other auditing standards
- Procedures to evaluate the quality and integrity of the data used by the company in developing the accounting estimate and by the auditor
- Explanation of the methods and judgements applied by the auditor's technical specialist within the audit documentation
- As well as a memorandum summarising the results of their work, the auditor's technical specialist evidenced their procedures on the audit file
- Clear evidence of the basis for the auditor's conclusion that the accounting estimate is reasonable
- Procedures performed by both the auditor and their technical specialists to evaluate the financial statement disclosures
- Clear communication to those charged with governance on the risks and results of procedures performed by the auditor

Case study: what does poor practice in auditing accounting estimates look like?

The following case study illustrates poor practice in the audit of an accounting estimate.

Case study background

In this case study, the company held financial assets and measured these assets at their fair value. The financial assets were categorised into three categories based on their fair value hierarchy, depending on how complex it was to value the financial asset. Level 1 financial assets were considered to be the easiest assets to value, level 2 were more difficult and level 3 were the most complex. The financial assets were assigned to one of these categories based on market depth, which refers to the frequency of trading of an asset. Level 1 assets were frequently traded and therefore valued using those trade values. Level 2 were traded less frequently and level 3 had no or limited trading value. The company's investment manager valued certain financial assets, in the absence of readily observable inputs or measures.

How did the auditor assess the risk of material misstatement?

The auditor assigned a significant risk to the valuation of the financial assets.

How did the auditor respond to the significant risk associated with the accounting estimate?

The auditor selected a sample of financial assets held at the year-end and obtained independent "pricing support". The auditor discussed the valuation process with the company's investment manager, reviewed level 2 and level 3 valuations for reasonableness and reviewed post year-end payment reports for post year-end sales to assess whether the valuations were reasonable.

What demonstrated "poor practice" in this case study?

- The "pricing support" used by the auditor was a spreadsheet provided by the company's administrator. There was insufficient evidence of the auditor performing procedures to check the accuracy and completeness of the information provided within this spreadsheet.
- There was insufficient evidence of how the auditor tested the valuations prepared by the company's investment manager. Specifically, it was not clear whether the auditor evaluated the model used by the investment manager in their valuations and there was insufficient evidence of the application of professional scepticism and challenge of management on the suitability of the valuations.
- It was not clear how the auditor verified the depth levels that were used to categorise the financial assets into their fair value hierarchy buckets. The unobservable inputs used by the company to value certain financial assets were unclear and there was no evidence that the auditor performed audit procedures in relation to any unobservable inputs.

IAASA's key recommendations on accounting estimates

In 2019, IAASA's key recommendations relating to the audit of accounting estimates set out that the following improvements are needed:

In assessing the risk of material misstatement associated with accounting estimates, auditors should:

- evaluate the model used in determining the accounting estimates
- evidence their understanding of how accounting estimates are made, including:
 - whether management have used an expert
 - 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
 - relevant controls
 - whether and, if so, how management has assessed the effect of estimation uncertainty

For accounting estimates that have been assessed as significant risks, auditors should:

- evidence their evaluation of the design and implementation of controls relating to the accounting estimates.
- perform procedures to understand all of the controls in place throughout the end-to end process in determining the accounting estimates

In auditing the assumptions applied by management when making an accounting estimate, auditors need to:

- evidence the procedures performed to identify and evaluate the significant assumptions used by management in determining accounting estimates
- clearly demonstrate their evaluation of whether the judgements and decisions applied in making the accounting estimate, even if they are individually reasonable, indicate a possible bias on the part of the entity's management
- evidence sufficient procedures to verify the completeness and integrity of the data used by management's expert in determining accounting estimates

When auditing information prepared by a management's expert, auditors need to:

- evidence their evaluation of the competence, capabilities and objectivity of the management's expert
- clearly demonstrate their understanding of the work of management's expert, including the resolution of any issues identified in the work of the expert and the appropriateness of that expert's work
- evaluate the sufficiency and appropriateness of the management's expert's work around the accuracy of data used by them in preparing the accounting estimate

When using the work of an auditor's expert, auditors need to:

- understand the field of expertise of the auditor's expert and evaluate whether the auditor's expert has the necessary competence, capabilities and objectivity for the auditor's purposes
- evidence their communications agreeing the scope, nature and objectives of the expert's work and the nature, timing and extent of communications between the auditor and the expert, including the form of report to be provided by the expert
- ensure that there is sufficient evidence of review of an auditor's expert's work when a report from an auditor's expert is used
- perform sufficient audit procedures to evaluate the relevance of the auditor's experts' work
- evaluate of the relevance, completeness, and accuracy of source data that is significant to the auditor's expert's work and their evaluation of any limitations in information available to the auditor's expert

- evidence their evaluation of the work of the auditor's expert, ensure there is evidence of sufficient audit procedures performed to review and challenge the results of the procedures performed by the auditor's expert
- evaluate whether samples tested by the auditor's expert were sufficient to reduce sampling risk to an acceptably low level and evaluate of the completeness and accuracy of the data used by the expert to select the sample

When reviewing financial statement disclosures relating to accounting estimates, auditors should:

- perform sufficient procedures to assess the appropriateness of the information presented

IAASA's expectations

The nature and extent of findings observed by auditing regulators demonstrate a clear need for improvements in the quality of audit work in certain aspects of accounting estimates.

IAASA expects auditors to continue to address the recommendations raised. IAASA will continue to review auditors' evaluation of the work of an auditor's expert and will seek to understand how auditors engage with these experts as well as how auditors review, evaluate and challenge the expert's work. When management have engaged an external expert, IAASA will continue to consider whether the auditor adequately evaluated the work performed by management's expert and the conclusions reached. IAASA will also continue to review the financial statement disclosures associated with accounting estimates, seeking to understand how auditors are satisfied that the information presented is appropriate.

In light of the changes in ISA 540 (revised), IAASA's review of the audit of accounting estimates will be expanded to consider the application of professional scepticism and the application of other auditing standards in the audit of accounting estimates.

Professional Scepticism

In many instances, further rigour is needed to identify and evaluate the assumptions applied by management. ISA 540 (revised) sets out clear requirements for auditors to exercise professional scepticism in their audit of accounting estimates. Auditors will be required to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory and will be required to "stand back".

IAASA expects auditors to heed the application guidance around challenging assumptions, questioning the appropriateness of judgements and decisions and reconsider whether sufficient appropriate audit evidence has been obtained.

When inspecting audits of accounting estimates applying ISA 540 (revised), IAASA will continue to seek to understand how the auditor evaluates significant assumptions. IAASA will consider whether the auditor evaluated:

- the appropriateness of significant assumptions in the context of the applicable financial reporting framework,
- the appropriateness of any changes in significant assumptions from prior periods,
- any indicators of possible management bias in their selection,

- the consistency of significant assumptions with each other and with those used in other accounting estimates and,
- whether management has the intent and ability to carry out specific courses of action

Interaction with other auditing standards

Although there is a specific auditing standard for accounting estimates, the requirements of all other auditing standards also apply. Many of the findings and recommendations in relation to the audit of accounting estimates relate to failure to apply the requirements of auditing standards around risk assessment, responses to significant risks, reliance on information produced by the entity, and placing reliance on the work of a management's expert. IAASA expects that the explicit cross-reference within ISA 540 (revised) to other relevant auditing standards will more clearly guide auditors in the requirements around testing controls for significant risks and the use of management's experts.

When inspecting audits of accounting estimates applying ISA 540 (revised), IAASA will review whether the auditor obtained an adequate understanding of the relevant matters about the entity and its environment relating specifically to the accounting estimate, including the entity's internal control management's process for determining the accounting estimates. IAASA will review auditors' judgements around estimation uncertainty and the complexity and subjectivity of methods, assumptions and data used in making the accounting estimate. Where significant risks are identified, IAASA will review the procedures performed to support the auditor's conclusions on the effectiveness of the design of the controls and the extent to which the controls address the assessed inherent risks at the assertion level. IAASA will seek to understand how the auditor's understanding of these factors drives their assessment of inherent risk and control risk at the assertion level for accounting estimates.

Reporting

Auditors will soon begin to apply ISA 540 (revised) and audit regulators will start to review this work in the latter part of 2021. Key recommendations arising in this area will be communicated by IAASA within the reports on the quality assurance reviews on each audit firm; these reports are published by IAASA's in the first quarter each year³.

³ Quality assurance review reports are published on IAASA's website, see <https://www.iaasa.ie/Publications/Quality-Assurance-Review-Reports>



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