Sri Lanka Auditing Standard 540
Audit of Accounting Estimates

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Overview

- Introduction

- What are accounting estimates

- Estimation Uncertainty

- Audit responses

2

New AuAuditing Standards

- Previously:
  - the auditor was permitted to rely upon the assumption of management's good faith and integrity
- Now…

Objectives in Revising SLAuS 540

- To increase the rigor and skepticism to be applied in auditing accounting estimates

- To provide enhanced guidance on estimation uncertainty and management bias

- SLAuS 315 and SLAuS 330 discussed risk based audit approach

3

Auditor's Objective

- Auditor should obtain sufficient appropriate audit evidence regarding accounting estimates

  - accounting estimates, are reasonable; and

  - related disclosures are adequate

4

What are Accounting estimates?

- "Accounting estimate" refers to approximation of amount of item in absence of precise means of measurement

  - Allowance for bad debts, inventory

  - Deferred tax

  - Provision for loss from a lawsuit

  - Losses in construction contracts in progress

  - Provisions for warranty claims

  - Actuarial valuations

  - Impairment testing etc etc

- FV are also estimates that are specifically addressed in SLAuS 545

5

Who is responsible?

- Management is responsible for making such estimates
    - Estimates are often made in conditions of uncertainly and uses judgment
    - Risk of misstatement greater because of element of uncertainty

6

Nature of Estimation Uncertainty

- The susceptibility of an accounting estimate to an inherent lack of precision in its measurement
- The degree of estimation uncertainty affects the risk that the financial statements are materially misstated and whether an estimate is particularly susceptible to management bias

Nature of accounting estimates

- Determination of estimate may be:
  - Simple (e.g. rent accrual) or Complex (e.g. slow-moving inventory)

- Estimates may be:
  - Done as part of routine accounting system, operating continuously or Non-routine, being done only at period-end

- Often done by applying formula based on experience
  - Formula should then be reviewed regularly by management

- Item may be incapable of reasonable estimation
  - Auditor must then consider effect on his report

7

Audit Procedures and evaluation

Audit procedures

- Auditor should obtain sufficient appropriate audit evidence as to whether estimate is reasonable and appropriately disclosed
  - Understanding of the entity and environment
  - Internal controls
- Understanding of the procedures and methods including relevant control activities, used by the management helps the auditor to design the N, T & E

8

Audit approaches

- Three audit approaches (can be combined):
  1. Review and test process used by management to develop estimate
  2. Compare independent estimate with management's
  3. Review subsequent events confirming estimate

9

Audit approaches

1. Reviewing and testing process used by management

   – Evaluation of data and consideration of assumptions on which estimate is based

   – Testing of calculations involved

   – Comparison of estimates for prior periods with actual results

      • Why?

   – Consideration of management's approval procedures

10

Audit approaches (continued)

2. Use of independent estimate

   – Auditor would ordinarily:

      • Evaluate data

      • Consider assumptions

      • Test calculation procedures

3. Review of subsequent events

   – Events after year-end but before completion of audit may provide audit evidence regarding estimate

      • E.g. provision for bad debts or obsolete stock

11

- Auditor should make final assessment of reasonableness of estimate, based on:

  – His knowledge of business

  – Whether estimate is consistent with other audit evidence obtained during audit

- Evaluation of differences can be difficult due to element of uncertainty

  – If there is difference, auditor should consider if adjustment is required

    - If yes, and management refuses to revise their estimate: difference should be regarded as misstatement

12

Discussion: Practical scenario

- Auditing actuarial valuation of gratuity

8

Conclusion

- Estimates are inherently imprecise and most of the numbers in FS are not facts, but estimates

- Evaluate Assumptions

- Determine Appropriateness of Model

- Test the data and calculations

- Use independent estimates,

- Review subsequent events

12

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