

## AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES: CAS 540

### Risk Assessment Procedures and Related Activities

- Obtain an understanding of the following to **identify and assess the risks of material misstatement** for accounting estimates
  - The **requirements of the applicable GAAP** relevant to accounting estimates
  - How management **identifies transactions** that may give rise to accounting estimates by making **inquiries of management** about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates
  - How **management makes accounting estimates**, and an understanding of the data on which they are based, including:
    - The **method** used in making the accounting estimate
    - Relevant **controls**
    - Whether management has used an **expert**
    - The **assumptions** underlying the accounting estimates
    - 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
    - Whether and, if so, how management has assessed the effect of **estimation uncertainty**
  - Review the **outcome of accounting estimates** included in the prior period F/S , or, where applicable, their subsequent re-estimation for the purpose of the current period

### Identifying and Assessing the Risks of Material Misstatement

- Evaluate the degree of estimation uncertainty associated with an accounting estimate
  - **Estimation uncertainty is** the susceptibility of an accounting estimate and related disclosures to an **inherent lack** of precision in its measurement.
- Determine if any of the accounting estimates that have been identified as having **high estimation uncertainty** give rise to **significant risks**

### Responses to the Assessed Risks of Material Misstatement

- Based on the assessed risks of material misstatement, determine:
  1. Whether management has **appropriately applied the requirements of the applicable GAAP** relevant to the accounting estimate
  2. Whether the **methods for making the accounting estimates are appropriate** and have been applied **consistently** and whether changes in accounting estimates or in the method for making them from the prior period are appropriate
- In responding to the assessed risks of material misstatement, shall undertake **one or more of the following**:
  1. Determine whether **events occurring up to the date of the auditor's report** provide audit evidence regarding the accounting estimate
  2. Test how management made the accounting estimate and the data on which it is based, by evaluating:
    - The method of measurement used is appropriate in the circumstances
    - If the assumptions used by management are reasonable per GAAP
  3. Test the operating effectiveness of the controls over how management made the accounting estimate
  4. Develop a point estimate or a range to evaluate management's point estimate

- The auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate

#### Further Substantive Procedures to Respond to Significant Risks

- For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed, evaluate the following:
  - How management has considered **alternative assumptions or outcomes**, and **why it has rejected them**, or how management has **otherwise addressed estimation uncertainty** in making the accounting estimate
  - Whether the **significant assumptions** used by management are reasonable
  - If significant assumptions are reasonable, management's intent to carry out specific courses of action and its ability to do so
- If the auditor judges that **management has not adequately addressed the effects of estimation uncertainty** on the accounting estimates that give rise to significant risks, the auditor should **develop a range with which to evaluate the reasonableness of the accounting estimate**
- For accounting estimates that give rise to **significant risks**, obtain sufficient appropriate audit evidence about whether management's decision to recognize, or to not recognize, the accounting estimates in the F/S and the selected measurement basis for the accounting estimates are in **accordance with GAAP**

#### Indicators of Possible Management Bias and Written Representations

- Review the **judgments and decisions** made by management in the making of accounting estimates to identify whether there are indicators of **possible management bias**
- Obtain **written representations** from management and those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable

#### Documentation

- Document the following:
  - Basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and
  - Indicators of possible management bias