AUDIT OF ACCOUNTING ESTIMATES

Highlights of Technical Clinic

BY
NARISSA CHEN

Accounting estimates have always been intriguing to the stakeholders on how the amounts were derived, perplexing to the management on how to come up with the amounts, and challenging to the auditors on how to audit the amounts. In the absence of precise means of measurement, accounting estimates conveniently become an area that is susceptible to management's bias.

Rick Chan, Partner, Head of Audit and Assurance, and Head of Technical and Training of Mazars LLP, facilitated this topic among a group of practitioners at ISCA's monthly technical clinic. Here are the highlights of the discussion.

1 WHY IS AUDIT OF ACCOUNTING ESTIMATES SO CHALLENGING? WHY ARE AUDITORS SPENDING SO MUCH TIME AND EFFORT CHALLENGING THESE NUMBERS?

Accounting estimates often require significant inputs from the client's management. Based on their depth of experience and knowledge in their operations and industry, management substantiates accounting estimates using information available to them from various sources. The nature and reliability of information may vary widely and affect the subjectivity associated with those estimates. In short, there are no precise means of measurement. Therefore, the appropriateness of the amount becomes very subjective and is subject to potential bias in management's judgement, whether intentionally or unintentionally. Hence, it is important for auditors to put in sufficient time and effort, and they must also have the necessary skill-set to challenge any estimates made by management. The auditor should gather sufficient and reliable information so as to form an independent expectation of the amount or at least, a reasonable range within which the amount would fall.

One of the key practical challenges faced by the auditors is their lack of comparable knowledge in the client's operations and industry, especially in situations where the client operates in a specialised or niche industry. Information may not be readily available in the market and independent experts, if available and accessible, may be costly.

Auditors occasionally find themselves caught in situations where management, who are experts in their respective fields, counter-challenge the relevance and adequacy of the auditors' corresponding experience and knowledge when they query the reasonableness of the assumptions made by the management.

Having limited knowledge of the products and the industry,

PHOTO SHUTTERSTOCK

inadvertently and inevitably, the auditors find themselves having to rely – sometimes to a significant extent – on the management's representation.

2 HOW CAN AUDITORS EVALUATE THE REASONABLENESS OF ACCOUNTING ESTIMATES IN SOME OF THE MORE COMMON AREAS WITH ESTIMATION UNCERTAINTIES?

Some areas involving estimation uncertainties that are frequently encountered, and certain corresponding audit procedures that can be performed, are laid out below:

(a) Inventory obsolescence

In a case brought up during the discussion, an entity trading in

"With continued scrutiny over the area of accounting estimates, auditors should exercise an appropriate level of professional skepticism in this area. To be professionally skeptical means that the auditor needs to have a questioning mind, be alert and be able to critically assess the adequacy and appropriateness of the audit evidence gathered as well as management's representations obtained throughout the course of the audit."

RICK CHAN
PARTNER, HEAD OF AUDIT AND ASSURANCE, AND HEAD OF TECHNICAL AND TRAINING, MAZARS LLP

certain chemical products wrote down its inventories aged more than three months on the basis that these products have reached their expected shelf life for actual retail. It was, however, observed that the entity continued to keep these inventories as they could be used for other purposes or sold at a secondary market. In the year of the audit, there was no evidence of subsequent sales. Hence, the anticipated selling price and the actual useful life of the chemical products became highly subjective.

Audit procedures that were suggested during the discussion included the following:

- Understand the client's business, industry and economic events that will affect the company. This includes understanding the nature of client's inventories, for example, average shelf life, effect of technological obsolescence, product life cycle, etc. Auditor needs to obtain corroborative evidence with regard to saleability of the client's inventories after they expire – whether there is a secondary market for the expired products and whether there have been subsequent sales for expired products historically;
- Attend physical inventory count to observe the physical condition of the inventories;
- Where applicable, enquire whether there is a group accounting policy on inventory obsolescence. If yes, management should assess the relevance of the group accounting policy to the company and to adapt the accounting policy to the local situation. Auditors would then need to assess the appropriateness of such adaptation;
- Corroborate management's representations and assumptions used, which may warrant obtaining a report of a sample chemical product, where available, to certify the product quality and shelf life. An element of unpredictability can also be introduced by sending a product sample to an independent research company for separate testing, with the results sent directly to the auditors. Where applicable, auditors may consider an expert report from the company's research/product quality department, provided that the said department has the expertise to assess product quality and their key performance indicators are not driven by sales;
- Perform a retrospective review of historical write-down of inventories for the last three years (or more if deemed necessary), and
- Perform subsequent events review where auditors should take note of any subsequent reversal of write-down of inventories and the reasons thereof. Any significant differences or unusual movements would indicate the need for reassessment of the estimates.

(b) Impairment of receivables

Assessment for any impairment of receivables can sometimes involve considerable judgement over two areas – creditworthiness of the counterparty, and the probability of default on specific long outstanding invoices.

Often, management insists on non-impairment on the bases that they have been dealing with the counterparty, and are optimistic about recovering the amounts given the ongoing transactions and communication with the counterparty.

Rather than taking management's representation at face value, audit procedures that can be performed include the following:

- For debtors with significant outstanding balances, perform review of the collection history of the debtor in question;
- For long outstanding receivables, enquire with management and corroborate management's representation on whether the invoice is under dispute and/or whether any payment plan has been agreed with the debtor. Where deemed necessary, perform a financial health check on the counterparty, and
- Follow up with management, where applicable, on the status of negotiation with the counterparty and subsequent collection till the date of auditor's report.

(c) Provision for warranty

Management tends to rely on past experience for the purpose of estimating provision for warranty. Often, the basis for provision remains the same year after year but the auditors should confirm that this is indeed the case. Corresponding audit procedures commonly performed by auditors include the following:

- Understand the warranty period extended to customers

PHOTO SHUTTERSTOCK

to assess the appropriateness of management's estimates;

- Assess the appropriateness of the client's accounting policy relating to warranty provision and the assumptions used in arriving at the provisional amount;
- Perform a retrospective review of the historical return rates and study the average product return over the years for any trends;
- Compare the client's average product return rate to the industry benchmark, if any, and
- Review for any major write-back or utilisation of provision subsequent to the reporting period which could indicate the need for reassessment of the estimates.

It is, however, also important to take note that the audit risk over the completeness of provision increases when the entity is, for example, introducing new products to the market or when there is a change in the production lines that may affect the quality of the inventories sold. Accordingly, auditors should tailor their audit procedures to address the heightened risk.

3 IF THERE IS A DISAGREEMENT ABOUT THE AMOUNT OF THE ACCOUNTING ESTIMATES BETWEEN AUDITORS AND CLIENT'S MANAGEMENT, WHAT CAN THE AUDITORS DO?

Auditors should assess the magnitude of the difference individually and collectively with other misstatements to evaluate if the effect of misstatements is material to the financial statements as a whole. If the difference is material to the financial statements, the auditors may consider issuing a modified audit opinion.

4 SHOULD AUDITORS OBTAIN WRITTEN REPRESENTATIONS FROM CLIENT'S MANAGEMENT REGARDING ACCOUNTING ESTIMATES? IF YES, WHAT IS THE RELEVANT INFORMATION TO BE INCLUDED IN THE WRITTEN REPRESENTATIONS?

Yes, information that can be included in the written representations includes key estimates and assumptions used by management in deriving the estimates, such as the growth rates and the discount rate used, all the key assumptions made, etc.

With continued scrutiny over the area of accounting estimates, auditors should exercise an appropriate level of professional skepticism in this area. To be professionally skeptical means that the auditor needs to have a questioning mind, be alert and be able to critically assess the adequacy and appropriateness of the audit evidence gathered as well as management's representations obtained throughout the course of the audit. ISCA

Narissa Chen is Senior Manager, Audit Technical, Training and Quality Control, Mazars LLP.