CHAPTER 1

Accounting estimates

This article aims to:

- Highlight changes to guidance on accounting estimates under IFRS and expected under Ind AS.
- Summarises the auditing guidance in relation to accounting estimates.

The current IAS 8 (Ind AS 8), *Accounting Policies, Changes in Accounting Estimates* and Errors does not define the term 'accounting estimate' instead it defines the term 'change in accounting estimate'.

The International Accounting Standards Board (IASB) observed that entities faced difficulties in distinguishing changes in accounting policies from changes in accounting estimates. This was due to the fact that definition of a change in accounting estimate in the standard was not sufficiently clear.

Distinguishing between accounting policies and accounting estimates is important because changes in accounting policies are generally applied retrospectively, while changes in accounting estimates are applied prospectively. The approach taken can therefore affect both the reported results and trends between periods.

Therefore, the IASB issued amendments to IAS 8 to clarify how companies should distinguish changes in accounting policies from changes in accounting estimates, with a primary focus on the definition of and clarifications on accounting estimates.

In response to change in IAS 8, the Accounting Standards Board of the Institute of Chartered Accountants of India (ICAI) has issued an exposure draft which is proposed to be effective on 1 April 2023 corresponding to amendments in IFRS Standard IAS 8.

New definition

The amendments to IAS 8 are summarised below:

- The new definition of accounting estimate is that **'Accounting estimates are monetary amounts in financial statements that are subject to measurement uncertainty.'**
- Clarify the relationship between accounting policies and accounting estimates by specifying that a company develops an accounting estimate to achieve the objective set out by an accounting policy.
- Developing an accounting estimate includes both
  - Selecting a measurement technique (estimation or valuation technique)
  - Choosing the inputs to be used when applying the chosen measurement technique.

The amended standard explicitly provides some examples of estimates to be developed by management based on the applicable financial reporting framework. These are:

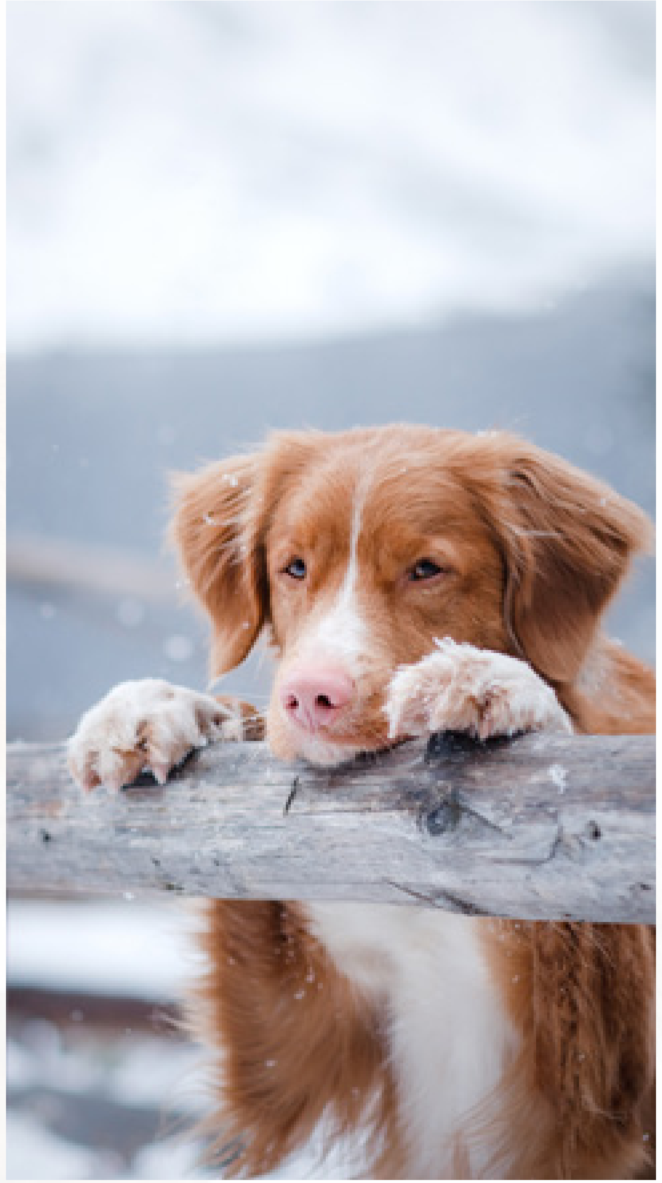
a. Loss allowance for expected credit losses, applying IFRS 9, *Financial Instruments*
b. The net realisable value of an item of inventory, applying IAS 2 *Inventories*
c. The fair value of an asset or liability, applying IFRS 13, *Fair Value Measurement*
d. The depreciation expense for an item of property, plant and equipment, applying IAS 16, *Property, plant and equipment*.

The definition of accounting policies remains unchanged.

It is pertinent to note that the revised definition of accounting estimates in IAS 8 is similar to the definition in the existing Standard on Auditing (SA) 540, *Auditing Accounting Estimates*.

As per SA 540, an accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

This SA deals with the auditor's responsibilities regarding accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. It further expands on how SA 315, *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment* and SA 330, *The Auditor's Responses to Assessed Risks and* other relevant SAs are to be applied in relation to accounting estimates. The standard also highlights the responsibilities of management towards identifying, making, and disclosing an accounting estimate.



Management's responsibility

It is management's responsibility to identify those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial statements. These would be based on management's understanding of the business and industry.

Elements of an accounting estimate as per the auditing standard

Determination of an accounting estimate depends on few elements e.g. selection of an accounting policy, method, assumptions and data. Management will establish a process for making an accounting estimate, including internal controls. These would include:

a. Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models. Management is required to use measurement techniques and inputs as per the applicable financial reporting framework in order to develop an estimate, for example, the technique as mentioned in Ind AS 109, *Financial Instruments* to measure loss allowance for expected credit losses. However, there may be situations where there are no specific methods prescribed by the applicable financial reporting framework.

b. Developing or identifying relevant data and assumptions that affect accounting estimates. The assumptions made by management should be supported by external or internal information sources.

   There may be situations based on specialised, technical and/or unusual nature of an accounting estimate where management may need to engage an expert to make or assist in making the accounting estimate. Such assumptions, when used by management, become management's assumptions.

c. Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

Estimation uncertainty

Accounting estimate and its related disclosure are susceptible to an inherent lack of precision in its measurement which is called as estimation uncertainty. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake a sensitivity analysis.

Auditor's responsibility

While auditing an accounting estimate an auditor would be identifying and assessing the risk of material misstatement associated with an accounting estimate where there is likelihood of estimation uncertainty. Where there is an estimation uncertainty then an auditor shall further evaluate whether there is a significant risk. Therefore, SA 540 requires an auditor to perform procedures to obtain an understanding for the process of development of the accounting estimates (i.e. identification and assessment of risk of material misstatement). An auditor would understand on how management:

- Identifies accounting estimates
- Develops the accounting estimates basis the method, assumption and data used
- Whether appropriate controls are in place
- How management assesses the effect of estimation uncertainty.

After understanding the process of development of the accounting estimates (i.e. identification and assessment of risk of material misstatement), an auditor would need to perform certain audit procedures. These procedures may include the following :

- Audit evidence from events occurring up to the date of the auditor's report
- Testing how management made the accounting estimate and the data on which it is based
- Testing the operating effectiveness of management controls, together with appropriate substantive procedures
- Developing the auditor's point estimate or range.

In addition to the above procedures, for accounting estimates that give rise to significant risks, the auditor needs to further evaluate:

- How management has addressed estimation uncertainty
- Whether the significant assumptions used by management are reasonable.

ISA 540 revised?

The International Auditing and Assurance Standard Board (IAASB) based on its outreach activities realised that the accounting estimates is a key area where enhanced auditing standards are required to enable an auditor to deal with increasingly complex accounting estimates and the related disclosures. Accordingly, IAASB revised the International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates and Related Disclosures*, (ISA 540 (Revised)). While the broad outline as mentioned in the earlier version of ISA 540 towards management and auditor's responsibilities remains same, there are certain key concepts that have been included and/or amended.

Since measurement of accounting estimates is subject to estimation uncertainty, it reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The ISA 540 Revised states that when management makes an accounting estimate it involves selecting and applying a method using assumptions and data, which requires judgement and can give rise to complexity in measurement.

Therefore, ISA 540 (Revised) provides guidance in relation to` the effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts.

Key considerations

Indicators of management bias

An auditor shall review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.

Communication to those charged with governance

An auditor would communicate with those charged with governance regarding significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively.