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| **Client:** | **$(client)** | |
| **Period end date:** | **$(start) - $(end)** | |
| **Ref. no.:** |  | |
| **Prepared by:** | $(user) | **Date:** |
| **Approved by Manager:** |  | **Date:** |
| **Approved by Partner:** |  | **Date:** |

# **Guidance (click to expand):**

Purpose

This template is designed to serve as a documentation template for an engagement team's understanding of certain matters of the entity and its environment and the applicable financial reporting framework, as well the entity’s system of internal control relating to accounting estimates. Therefore, the requirements in this document relate more specifically to accounting estimates and build on the broader requirements of understanding obtained earlier. This template shall be completed for each significant accounting estimate (when uncertainty, complexity or subjectivity are high).

Introduction

Accounting estimate is a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. Accounting estimates may include monetary amounts related to classes of transactions or account balances recognized or disclosed in the financial statements. Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition or disclosure relating to a class of transactions or account balance.

Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement.

The degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required would not be expected to be extensive. Moreover, not all accounting estimates are subject to estimation uncertainty. However, when estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive.

Examples of accounting estimates related to classes of transactions, account balances and disclosures include:

* Inventory obsolescence.
* Depreciation of property and equipment.
* Valuation of infrastructure assets.
* Valuation of financial instruments.
* Outcome of pending litigation.
* Provision for expected credit losses.
* Valuation of insurance contract liabilities.
* Warranty obligations.
* Employee retirement benefits liabilities.
* Share-based payments.
* Fair value of assets or liabilities acquired in a business combination, including the determination of goodwill and intangible assets.
* Impairment of long-lived assets or property or equipment held for disposal.
* Non-monetary exchanges of assets or liabilities between independent parties.
* Revenue recognized for long-term contracts.

Understanding accounting estimates

The auditor shall consider the matters listed in the table below when understanding accounting estimates and when completing this documentation template.

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| **The entity and its environment and the applicable financial reporting framework** |
| **The entity’s transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements** |
| Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:   * The entity has engaged in new types of transactions; * Terms of transactions have changed; or * New events or conditions have occurred. |
| **The requirements of the applicable financial reporting framework** |
| Consider the following:   * Whether the applicable financial reporting framework: * Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates; * Specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management’s intentions to carry out certain courses of action with respect to an asset or liability; or * Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and * Whether changes in the applicable financial reporting framework require changes to the entity’s accounting policies relating to accounting estimates. |
| **Regulatory factors** |
| Consider whether applicable regulatory framework(s):   * Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon; * Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework; * Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or * Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework. |
| **The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements** |
| Consider the understanding obtained of the above matters. |
| **The entity’s system of internal control** |
| **The nature and extent of oversight and governance that the entity has in place over management’s financial reporting process relevant to accounting estimates** |
| Consider whether those charged with governance:   * Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates; * Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework; * Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management’s actions when those actions appear to be inadequate or inappropriate; * Oversee management’s process for making the accounting estimates, including the use of models; or * Oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates. |
| **Management’s application of specialized skills or knowledge relating to accounting estimates, including the use of management’s experts** |
| Consider whether the following circumstances increase the likelihood that management needs to engage an expert:   * The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms. * The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values. * The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate. |
| **Entity’s risk assessment process relating to accounting estimates** |
| Consider whether and, if so, how management:   * Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates. * Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors. * Identifies financial or other incentives that may be a motivation for bias. * Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates. * Establishes appropriate oversight and review of models used in making accounting estimates. * Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates. |
| **The entity’s information system as it relates to accounting estimates** |
| Understand the classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures by considering:   * Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions; and * How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities. |
| Understand how management identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework by considering the following:   * How management selects or designs, and applies, the methods used, including the use of models:   + Whether there is a valid reason for change in method   + Whether the continued use of a method remains appropriate   + The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.   + How management determines the relevance and accuracy of the model;   + The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use.   + How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;   + Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and   + Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output. * How management selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions:   + The basis for management’s selection and the documentation supporting the selection of the assumption. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.   + How management assesses whether the assumptions are relevant and complete.   + When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity’s business activities, or with other matters that are:     - Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset’s useful life); and     - Outside the control of management (for example, assumptions about interest rates, mortality rates or potential judicial or regulatory actions).   + The requirements of the applicable financial reporting framework related to the disclosure of assumptions. * How management selects the data to be used:   + The nature and source of the data, including information obtained from an external information source.   + How management evaluates whether the data is appropriate.   + The accuracy and completeness of the data.   + The consistency of the data used with data used in previous periods.   + The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.   + How the data is obtained, transmitted and processed and how its integrity is maintained. |
| Understand how management understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes by considering the following:   * Whether and, if so, how management identified alternative methods, significant assumptions or sources of data that are appropriate in the context of the applicable financial reporting framework. * Whether and, if so, how management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate. |
| Understand how management addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements.  The requirements of the applicable financial reporting framework may specify the approach to selecting management’s point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognize that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.  The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty. |
| **Control activities relevant to the audit over management’s process for making accounting estimates** |
| Consider the following:   * How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers. * The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance. * The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity’s financial products staffed by individuals whose remuneration is not tied to such products. * The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data. |
| When management makes extensive use of information technology in making an accounting estimate, controls relevant to the audit are likely to include general IT controls and application controls. The auditor should further consider the following matters:   * Whether the information technology system has the capability and is appropriately configured to process large volumes of data; * Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention; * Whether the design and calibration of models is periodically evaluated; * The complete and accurate extraction of data regarding accounting estimates from the entity’s records or from external information sources; * Data, including the complete and accurate flow of data through the entity’s information system, the appropriateness of any modification to the data used in making accounting estimates, the maintenance of the integrity and security of the data; * When using external information sources, risks related to processing or recording the data; * Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and * Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries |

# **Understanding Accounting Estimates**

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| **Relevant financial statement area** | **The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements, based on the auditor’s understanding of:**   * **The entity’s transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements** * **Requirements of the applicable financial reporting framework** * **Regulatory factors** | **Management’s application of specialized skills or knowledge relating to accounting estimates, including the use of management’s experts** | **How management identifies**  **the classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures** | **How management identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework including how the management selects them** | **How management understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes** | **How management addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements** | **Other controls in place in relation to the accounting estimate:**   * **The nature and extent of oversight and governance that the entity has in place** * **Entity’s risk assessment process** * **Control activities** * **How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review** | **The outcome of accounting estimates included in prior period financial statements or, their subsequent re-estimation for the purpose of the current period (refer to relevant audit program)** | **Auditor’s assessment of the degree to which the accounting estimate is subject to estimation uncertainty** | **Auditor’s assessment of the degree to which the following are affected by complexity, subjectivity, or other inherent risk factors:**   * **The selection and application of the method, assumptions and data in making the accounting estimate; or** * **The selection of management’s point estimate and related disclosures for inclusion in the financial statements.** |
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