NSA 23

NEPAL STANDARDS ON AUDITING
AUDIT OF ACCOUNTING ESTIMATES

CONTENTS

This NSA is applicable in all material respects to Public Sector also.

Introduction

1. The purpose of this Nepal Standard on Auditing (NSA) is to establish standards and provide guidance on the audit of accounting estimates contained in financial statements. This NSA is not intended to be applicable to the examination of prospective financial information, though many of the procedures outlined herein may be suitable for that purpose.

2. This NSA is to be read in conjunction with the Preface to Nepal Standards on Auditing.

3. This NSA contains the basic principles and essential procedures (identified in bold type black lettering) together with related guidance in the form of explanatory and other material.

4. This NSA needs only be applied to material matters.

5. **The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.**

6. “Accounting estimate” means an approximation of the amount of an item in the absence of a precise means of measurement. Examples are:

- allowances to reduce inventory and accounts receivable to their estimated realisable value,
- provisions to allocate the cost of fixed assets over their estimated useful lives,
- accrued revenue,
- deferred tax,
- provision for a loss from a lawsuit,
- losses on construction contracts in progress, and
- provision to meet warranty claims.

7. Management is responsible for making accounting estimates included in financial statements. These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgement. As a result, the risk of material misstatement is greater when accounting estimates are involved.

The Nature of Accounting Estimates

8. The determination of an accounting estimate may be simple or complex depending upon the nature of the item. For example, accruing a charge for rent may be a simple calculation, whereas estimating a provision for slow-moving or surplus inventory may involve considerable analyses of current data and a forecast of future sales. In complex estimates, there may be a high degree of special knowledge and judgement required.

9. Accounting estimates may be determined as part of the routine accounting system operating on a continuing basis, or may be nonroutine, operating only at period end. In many cases, accounting estimates are made by using a formula based on experience, such as the use of standard rates for depreciating each category of fixed assets or a standard percentage of sales revenue for computing a warranty provision. In such cases, the formula needs to be reviewed regularly by management, for example, by reassessing the remaining useful lives of assets or by comparing actual results with the estimate and adjusting the formula when necessary.

10. The uncertainty associated with an item, or the lack of objective data may make it incapable of reasonable estimation, in which case the auditor needs to consider whether the auditor's report needs modification to comply with NSA 08, "The Auditor's Report on Financial Statements."

Audit Procedures

11. **The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate is reasonable in the circumstances and, when required, is appropriately disclosed.** The evidence available to support an accounting estimate will often be more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.

12. An understanding of the procedures and methods, including the accounting and internal control systems, used by management in making the accounting estimates is often important for the auditor to plan the nature, timing and extent of the audit procedures.

13. **The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:**

    (a) **review and test the process used by management to develop the estimate;**

    (b) **use an independent estimate for comparison with that prepared by management; or**

    (c) **review subsequent events which confirm the estimate made.**

Reviewing and Testing the Process Used by Management

14. The steps ordinarily involved in reviewing and testing of the process used by management are:

    (a) evaluation of the data and consideration of assumptions on which the estimate is based;

    (b) testing of the calculations involved in the estimate;

    (c) comparison, when possible, of estimates made for prior periods with actual results of those periods; and

    (d) consideration of management's approval procedures.

Evaluation of Data and Consideration of Assumptions

15. The auditor would evaluate whether the data on which the estimate is based is accurate, complete and relevant. When accounting data is used, it will need to be consistent with the data processed through the accounting system. For example, in substantiating a warranty provision, the auditor would obtain audit evidence that

the data relating to products still within the warranty period at period end agree with the sales information within the accounting system.

16. The auditor may also seek evidence from sources outside the entity. For example, when examining a provision for inventory obsolescence calculated by reference to anticipated future sales, the auditor may, in addition to examining internal data such as past levels of sales, orders on hand and marketing trends, seek evidence from industry-produced sales projections and market analyses. Similarly, when examining management's estimates of the financial implications of litigation and claims, the auditor would seek direct communication with the entity's lawyers.

17. The auditor would evaluate whether the data collected is appropriately analysed and projected to form a reasonable basis for determining the accounting estimate. Examples are the analysis of the age of accounts receivable and the projection of the number of months of supply on hand of an item of inventory based on past and forecast usage.

18. The auditor would evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate. In some cases, the assumptions will be based on industry or government statistics, such as future inflation rates, interest rates, employment rates and anticipated market growth. In other cases, the assumptions will be specific to the entity and will be based on internally generated data.

19. In evaluating the assumptions on which the estimate is based, the auditor would consider, among other things, whether they are:

- reasonable in light of actual results in prior periods;
- consistent with those used for other accounting estimates; and
- consistent with management's plans which appear appropriate.

The auditor would need to pay particular attention to assumptions which are sensitive to variation, subjective or susceptible to material misstatement.

20. In the case of complex estimating processes involving specialised techniques, it may be necessary for the auditor to use the work of an expert, for example, engineers for estimating quantities in stock piles of mineral ores. Guidance on how to use the work of an expert is provided in NSA 20, "Using the Work of an Expert."

21. The auditor would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates. Such a review would reflect the auditor's knowledge of the financial results of the entity in prior

periods, practices used by other entities in the industry and the future plans of management as disclosed to the auditor.

Testing of Calculations

22. The auditor would test the calculation procedures used by management. The nature, timing and extent of the auditor's testing will depend on such factors as the complexity involved in calculating the accounting estimate, the auditor's evaluation of the procedures and methods used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

Comparison of Previous Estimates With Actual Results

23. When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:

    (a) obtaining evidence about the general reliability of the entity's estimating procedures;

    (b) considering whether adjustments to estimating formulae may be required; and

    (c) evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Consideration of Management's Approval Procedures

24. Material accounting estimates are ordinarily reviewed and approved by management. The auditor would consider whether such review and approval is performed by the appropriate level of management and that it is evidenced in the documentation supporting the determination of the accounting estimate.

Use of an Independent Estimate

25. The auditor may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate the auditor would ordinarily evaluate the data, consider the assumptions and test the calculation procedures used in its development. It may also be appropriate to compare accounting estimates made for prior periods with actual results of those periods.

Review of Subsequent Events

26. Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and test the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

Evaluation of Results of Audit Procedures

27. **The auditor should make a final assessment of the reasonableness of the estimate based on the auditor's knowledge of the business and whether the estimate is consistent with other audit evidence obtained during the audit.**

28. The auditor would consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimate.

29. Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the auditor's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the auditor would determine whether such a difference requires adjustment. If the difference is reasonable, for example, because the amount in the financial statements falls within a range of acceptable results, it may not require adjustment. However, if the auditor believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material.

30. The auditor would also consider whether individual differences which have been accepted as reasonable are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the auditor would evaluate the accounting estimates taken as a whole.

Compliance with International Standards on Auditing

31. Compliance with this NSA ensures compliance in all material respects with ISA 540 (Audit of Accounting Estimates).

Effective Date

32. This Nepal Standards on Auditing becomes operative for the audit commencing on or after 01 Shrawan 2062 corresponding to 16 July 2005.. Earlier application is encouraged.