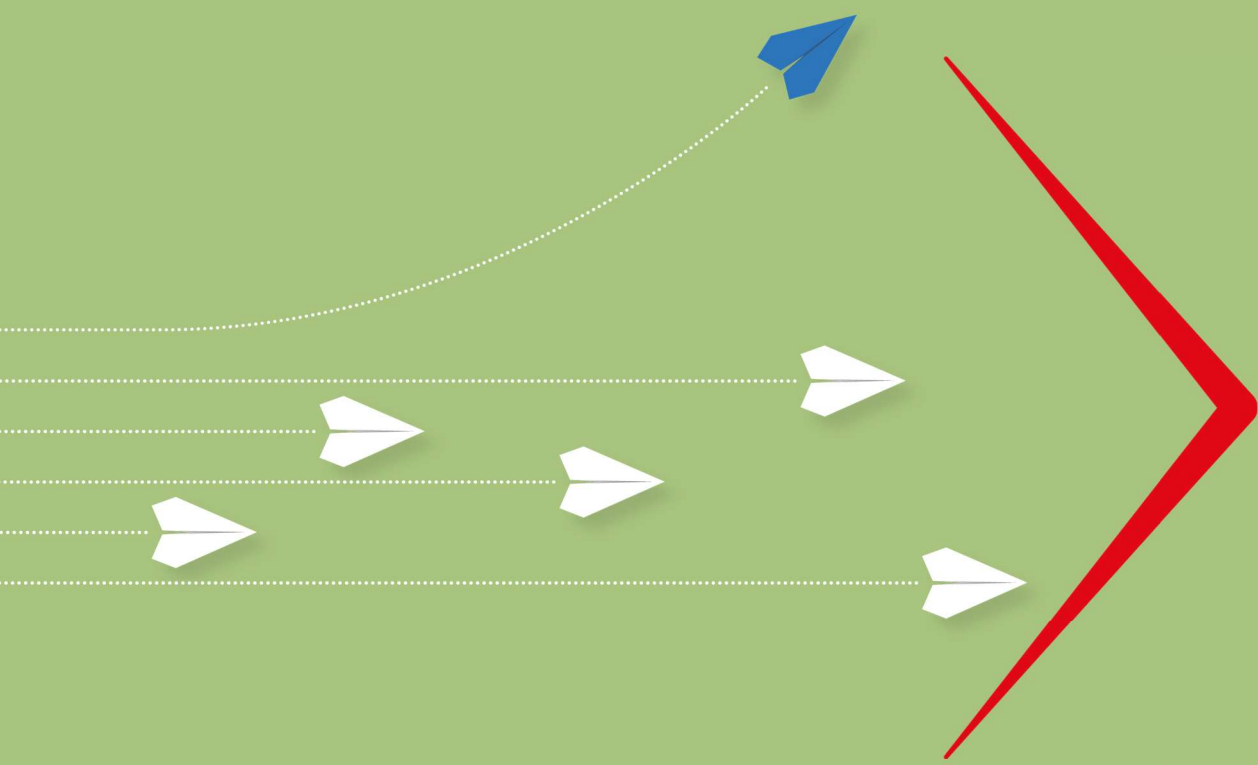


ICAEW KNOW-HOW  
AUDIT AND ASSURANCE FACULTY



*Auditing  
accounting  
estimates –  
provisions*

Andrew Paul

# *Contents*

What are we auditing?

Assessing the risk

How are we auditing?

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# *What are we auditing?*

- Almost all provisions are estimates!
- Examples ISA 540 (Revised) gives include:
  - Inventory obsolescence
  - Outcome of pending litigation
  - Expected credit losses
  - Warranty obligations
  - Long term contracts

# *Assessing the risk*

- Risk assessment based on inherent risk factors:
  - Estimation uncertainty
  - Complexity
  - Subjectivity
  - Other inherent risk factors such as fraud risk etc
- Depending on the area there could be one dominant risk factor or an accumulation of factors
- As with all risk assessments, these will always be unique to the client circumstances

# *Assessing the risk*

Example –

Slow moving / obsolete inventory

- Not very subjective
- Not very uncertain
- Could be complex to identify

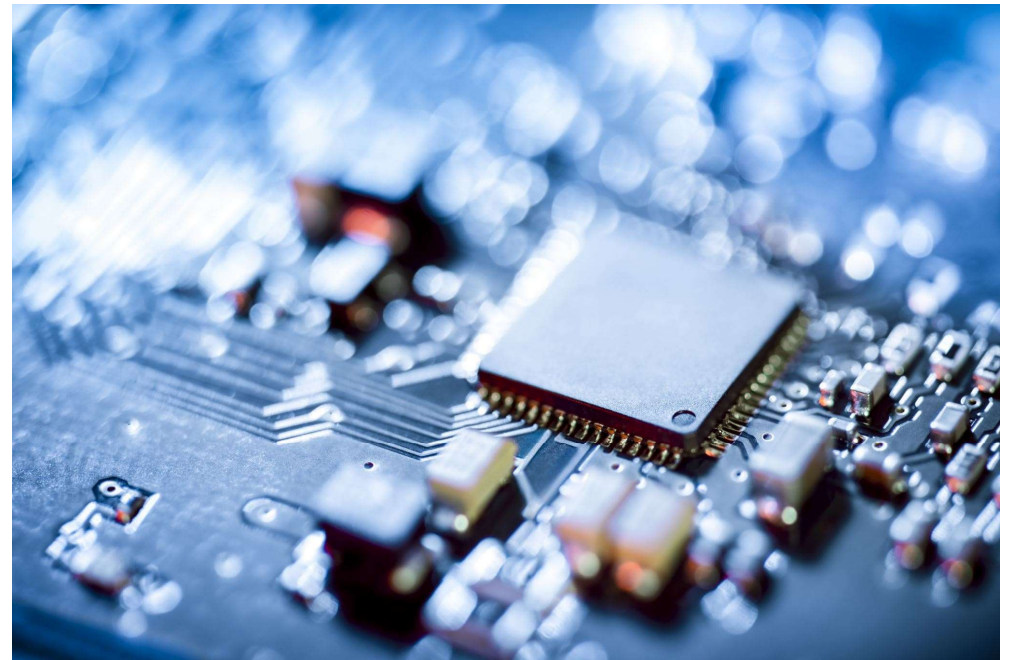


# *Assessing the risk*

Example –

Warranty provision for a new product

- Highly subjective
- Highly uncertain
- Potentially highly complex



# *How are we auditing?*

- We MUST maintain our professional scepticism (sic)
- Obtaining audit evidence from the events occurring up to the date of the auditor's report
- Testing how management made the accounting estimate
- Develop an auditor's point estimate or range

# *How are we auditing?*

Obtaining audit evidence from the events occurring up to the date of the auditor's report

- Could be difficult for provisions depending on the timing of the audit – are the matters resolved by the date of sign-off?



# *How are we auditing?*

Testing how management made the accounting estimate

- Don't just re-perform the maths!
  - Is the method appropriate?
  - Is there bias in the selection of the approach?
  - Are the significant assumptions valid?
  - Is the data included valid?

# *How are we auditing?*

Develop an auditor's point estimate or range

- The previous points still apply!
- Like any good analytical procedure, test the inputs as well as the method!
- Do your research
- Use your experience from other clients and industries

# *How are we auditing*

Example –

Slow moving / obsolete inventory

- If audit timing allows, look at the post year end sales activities and pricing
- Review the client's provision calculation
  - How did they arrive at the %
  - How did they decide which items to provide for?
- Auditor's estimate may not be appropriate or reasonable approach here

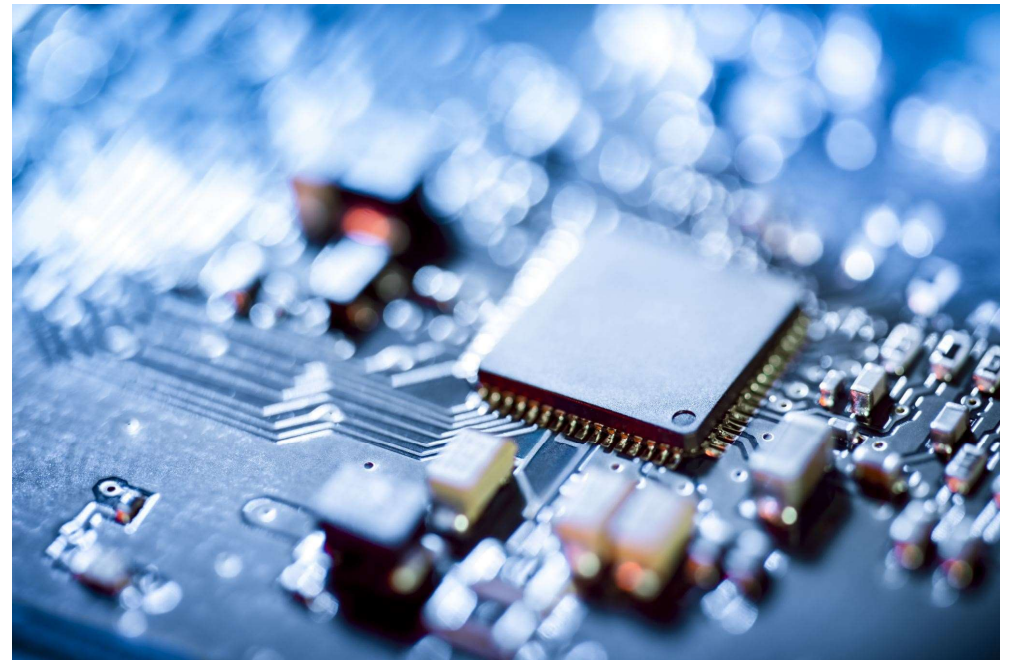


# *How are we auditing?*

Example –

Warranty provision for a new product

- Post year end review may not work here if, say, the client offers 12 month warranties – insufficient data to use.
- Review the client's calculation
  - Logic for return rates
  - Logic for cost of reparation
- Auditor's estimate
  - What have you seen with similar clients / industries?



# *What evidence should be on the file?*

- Understanding of the provision...why is it required, how is it calculated
- Risk assessment
- Linkage to the audit approach
- Detailed audit evidence to support the provision
- Significant judgements made
  
- Show your workings!



