Canadian Public Accountability Board
Conseil canadien sur la reddition de comptes

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Auditing accounting estimates: **Strengthening audit quality**

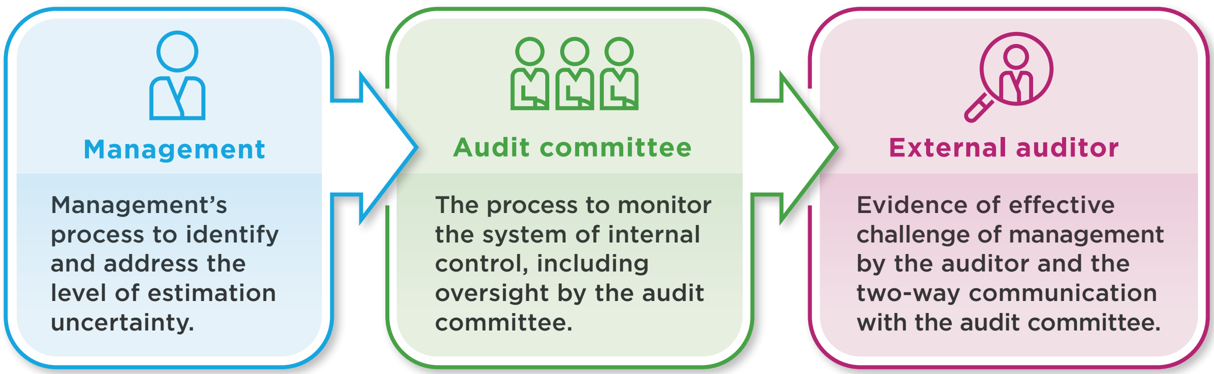
Higher estimation uncertainty

The current economic environment has increased the level of estimation uncertainty on critical accounting estimates, including going concern assessments/liquidity evaluations, complex valuations, impairment evaluations and estimating expected credit losses. The quality of audit work over accounting estimates continues to be an area with audit deficiencies and opportunities for improvement. Similar to the issues the Canadian Public Accountability Board (CPAB) highlighted in our 2020 CPAB Audit Quality Insights Report, the most common inspection findings continue to relate to auditing accounting estimates involving significant assumptions and judgments about future conditions or events.

While we have seen improvements, there is more to do. Although our inspection of audits conducted under Canadian Auditing Standards 540 (Revised) — *Auditing Accounting Estimates and Related Disclosures* (CAS 540) is still underway, we are sharing our preliminary observations to assist firms and engagement teams as they plan for their upcoming audits. We provide firm leadership with examples to clarify the issues related to audit deficiencies in this area, as well as some of the practices observed in files with no findings. We expect firms to develop targeted actions to improve the quality of audit work over accounting estimates. We emphasize the importance of holding management accountable for fulfilling their responsibilities, effective two-way communication with the audit committee and the importance of the role and mindset of auditors on exercising professional skepticism to achieve long term audit quality.

Why the revisions to CAS 540 are important

An audit conducted in accordance with CAS and relevant ethical requirements, including independence, is based on the premise that management and those charged with governance accept that certain responsibilities are fundamental to the conduct of an audit. As the degree of estimation uncertainty increases so should the nature and extent of oversight and governance the reporting issuer has in place over management's financial reporting process. Where the auditor concludes the methods, assumptions or data used are not appropriate in the context of the applicable financial reporting framework, the auditor needs to evaluate the significance and susceptibility to misstatement. This evaluation should not be performed by the auditor in isolation; it must include an understanding of how management has evaluated it and requesting management to perform additional procedures to address estimation uncertainty, where necessary. As the complexity, subjectivity and other inherent risk factors for the accounting estimate increases, it becomes less likely that the auditor can develop a point estimate or range without sufficient understanding of how management assessed and addressed the level of estimation uncertainty or compromising independence requirements.



Firm leadership must set the appropriate tone that recognizes and reinforces the firm's role in serving the public interest and the importance of holding management accountable. This includes the auditor's responsibility for evaluating any deficiencies identified in management's method, model or assumptions and evidencing judgments made on the impact to the design, implementation or operating effectiveness of internal controls when relevant. Where deficiencies are identified, they must be communicated to the appropriate level of management on a timely basis to allow for appropriate action. If management does not have the capabilities in-house it may be necessary to engage an expert. If management is unwilling to take the actions necessary or if there are concerns that the nature of the deficiencies raise questions about management's competence or integrity, such concerns must be communicated to the appropriate level of management and the audit committee, where appropriate.

Firm leadership is responsible for establishing an environment that demonstrates a commitment to audit quality, including reinforcing the importance of timely and transparent communication of deficiencies based on the likelihood and magnitude of potential misstatements. Timely communication of deficiencies assists in:

- Reinforcing management and audit committee responsibilities for the financial statements of the reporting issuer subject to audit.
- Reflecting the importance of the matters and assisting management and the audit committee in fulfilling their audit quality responsibilities.
- Supporting the auditor in maintaining independence and performing a high-quality audit.

Where management is unwilling or unable to appropriately address the level of estimation uncertainty, the auditor must evaluate whether the overall objectives of the audit in accordance with the CAS can be satisfied. Firm leadership needs to create and promote a culture that supports engagement teams in having difficult conversations with audit clients, which may include a delay in issuance of the financial statements.

What our inspections reveal

Common inspection findings

- Deficiencies in management's estimate approach were not effectively challenged.
- Inappropriate use of point estimates or ranges.
  - Point estimates or ranges were developed without sufficient understanding of how management assessed and addressed the level of estimation uncertainty.
  - Insufficient consideration of auditor independence.
- Insufficient or no consideration of contradictory evidence.
- No assessment of the impact of deficiencies on internal controls.

Practices observed in files without findings

- High involvement of senior engagement team members and others, as appropriate.
- Early involvement of specialised expertise by the auditor.
- Specific consideration and assessment of how management understood and addressed the level of estimation uncertainty.
- Evaluation of deficiencies identified in management's model, data and assumptions.
- The auditor performed a stand-back that included an evaluation of audit evidence obtained during the audit.

Although we found deficiencies across a range of estimates, the most prevalent occurred in the auditor's evaluation of complex estimates, such as the impairment of assets, fair value estimates for acquisitions and revenue recognized over time. We have observed a strong correlation between the quality of management's procedures to address the level of estimation uncertainty and the quality of the auditor's work, indicating this is still an area of challenge for the firms with respect to long term audit quality. The auditor may identify deficiencies in the method, assumptions or data but instead of requesting management to address these deficiencies, some auditors develop a point estimate or range without critically assessing whether this is appropriate in the circumstances and can be done without compromising auditor independence. The development of a point estimate or range unsupported by sufficient and appropriate audit evidence is not an appropriate response when management has not appropriately assessed or addressed the level of estimation uncertainty. In addition, there is often no evidence that the auditor evaluated whether a deficiency in internal control exists.

Consideration of contradictory evidence is often another area where auditors do not sufficiently challenge management. The auditor is required to obtain audit evidence in an unbiased manner and perform a stand-back assessment to evaluate both corroborative and contradictory evidence, even where the evidence is not directly related to the estimate. This is further reflected in the revised CAS 315, *Identifying and Assessing the Risks of Material Misstatement* which becomes effective for financial statement audits for periods beginning on or after December 15, 2021. Retaining audit evidence to support how the auditor identified and considered contradictory evidence, including significant judgments in their stand-back assessment and evidence of management challenge, is key to demonstrate they have exercised the appropriate level of professional skepticism.

Effective challenge of management and timely and transparent communications with the audit committee requires a high level of engagement of senior team members, involvement of specialized expertise and the support of firm leadership; these are critical to achieving consistent execution of high-quality audits.

Common inspection findings

Deficiencies in management's estimate approach were not effectively challenged

The auditor did not effectively challenge deficiencies in management's estimate or approach and there was no evidence that the auditor requested management to perform additional procedures to understand and address the level of estimation uncertainty.

- The auditor obtained management's analysis which concluded that the recoverable amount of the asset based on a value in use calculation exceeded the carrying value; accordingly, no impairment was recognized in the financial statements. The auditor concluded that the risk of material misstatement was at the lower end of the spectrum of inherent risk based on the substantial headroom in management's calculation. The procedures to support the risk assessment were limited to a high-level sensitivity analysis that included consideration of whether other reasonably possible assumptions would substantially reduce the amount of headroom. A sensitivity analysis is not a sufficient procedure on its own to support the auditor's risk assessment, specifically the appropriateness of the model used or the reasonableness of the significant assumptions.
- Material cash outflows related to corporate costs were excluded from management's discounted cash flow forecast. There was insufficient evidence to support how the auditor challenged management's assumption that the outflows were not necessary to generate the cash inflows or the assumption that they were not directly attributable or could not be allocated on a reasonable and consistent basis.
- Management's discounted cash flow model was missing key inputs that may have a material impact on the calculated recoverable amount. The auditor did not take this into account in their risk assessment; therefore, the planned audit approach was incomplete.
- Management's impairment analysis included unsupported cash flow assumptions not in compliance with the requirements of IAS 36, *Impairment of assets*. For example, management's cash flow forecast included unsupported revenue growth rates significantly above inflation and historical growth rates experienced by the reporting issuer or costs savings from future restructuring plans to improve profitability. There was insufficient evidence of how the auditor challenged management's assumptions.
- Management measured the fair value of investments based on net asset values of the underlying funds. Audit procedures were limited to obtaining the prior year audited financial statements. There was insufficient evidence to demonstrate how management or the auditor was satisfied that the net asset value of the underlying funds represented fair value, specifically, the method, data and assumptions used by the underlying fund manager for material level three investments.

Inappropriate use of point estimates or ranges

Auditors developed a point estimate or range without obtaining a sufficient understanding of how management assessed and addressed the level of estimation uncertainty.

- There was insufficient evidence to demonstrate the engagement team obtained an understanding of how management identifies and selects the assumptions to be used, including consideration of alternatives. The auditor's procedures were limited to comparing management's assumptions to publicly available information and there was insufficient evidence to demonstrate how comparable information was identified and how they were satisfied that the information was in fact comparable. For example, customer attrition rates included in management models were evaluated by comparing to general industry information without consideration of the actual historical attrition experienced by the reporting issuer for their customer or product base.

- Management recognized revenue over time as the performance obligation was satisfied based on costs incurred and expected gross margin. We observed the following deficiencies:
    - Insufficient evaluation of contract terms to support management's position that the performance obligation was satisfied over time.
    - Audit procedures were primarily inquiry with management; no procedures were performed over management's budgeting process to support whether costs incurred to date were included as part of the initial budget, represented change orders or were due to overruns.
    - Audit procedures were limited to high level substantive analytical procedures to analyze the margins on individual contracts using thresholds that were not sufficiently precise resulting in contracts with significant variances that were not identified and followed up.
- The auditor developed a point estimate or range to evaluate the fair value of deferred revenue acquired in a business acquisition without sufficient evaluation of the nature of the performance obligation to be satisfied in the future and the associated costs

Auditors developed a point estimate or range without appropriate consideration of independence.

- The auditor obtained management's impairment analysis and identified deficiencies in the model which the auditor addressed by developing a point estimate or range using their own internally developed model. The auditor's point estimate included higher expectations then those included in management's original estimate related to key assumptions such as revenue projections and gross margin.
- Material adjustments were made to management's impairment based on the point estimate developed by the auditor using a model and/or assumptions that were significantly different from managements.

The auditor did not request management to address the level of estimation uncertainty by reconsidering their point estimate or requesting management to obtain the support of an external expert where they do not have the expertise in-house.

Insufficient or no consideration of contradictory evidence

- The auditor's comparison of third-party information was cited as consistent with the auditor's knowledge of the reporting issuer or industry without sufficient information to demonstrate what information was used in forming their view, including how contradictory evidence was considered and evaluated.
- The auditor performed procedures, including developing a point estimate, which focused on corroborating management's position and did not perform a stand-back assessment to evaluate contradictory evidence or appropriately challenge management to provide a more robust assessment.

No assessment of the impact of deficiencies in internal control

Where deficiencies were identified in management's model, the auditor did not perform an assessment of the impact on the reporting issuer's internal controls. In response to CPAB queries, auditors often cite that the nature of the deficiency did not result in an adjustment to the financial statements or that the deficiencies have historically been communicated to management verbally. This is most often observed where management's impairment analysis has significant head room due to the inclusion of aggressive growth assumptions and/or an inappropriate discount rate. The auditor's assessment is inconsistent with the high level of estimation uncertainty associated with the estimate and does not take into consideration that the control as designed and implemented would not detect or prevent a misstatement of the financial statements should there be a change in the economic environment of the reporting issuer or the industry. The auditor's evaluation also does not take into consideration whether the deficiency warrants the attention of the audit committee. This is particularly important when the auditor has concerns over management bias or their competence and capability.

Practices observed in files with no findings[1]

High involvement of senior engagement team members and others, where appropriate

- There was evidence to demonstrate that senior engagement team members were involved in reviewing the audit working papers, communications with management and the audit committee and consultations with firm resources outside the engagement team where appropriate.
- The documentation in the file was robust and there was sufficient detail to demonstrate the significant judgments and how these were evaluated and concluded on by the engagement team.

Early involvement of specialized expertise

- The auditor involved an auditor's expert to perform risk assessment procedures and identify areas of higher risk of material misstatement, including assessment of the outcome of previous estimates, or where applicable, their subsequent re-estimation.
- Where the firm did not have the specialized expertise in-house, an external expert was engaged.

Specific consideration and assessment of how management understood and addressed the level of estimation uncertainty

- The auditor's evaluation of management's impairment assessment included consideration of factors specific to the reporting issuer such as the impact of the COVID-19 pandemic and other external factors such as industry and geography that supported their conclusion and demonstrated their consideration of contradictory evidence.
- Management's going concern and impairment analyses included various scenarios. The evidence demonstrated the auditor's effective challenge of the appropriateness of management's scenarios and consideration of other reasonably possible outcomes.
- Point estimates or ranges were used to support significant assumptions or data external to the reporting issuer to evaluate management's assumptions. For example, the components of management's discount rate were evaluated individually and compared to third-party information where appropriate which was further assessed for comparability. The impact of any contradictory information was also factored into the auditor's evaluation.
- Where management took an over-simplified estimate approach, the auditor requested management to perform additional procedures.
- Communications with the audit committee clearly communicate the work performed, the nature of any deficiencies identified and how these were evaluated. The auditor's documentation also contained sufficient documentation to understanding the quality of the discussions with the audit committee.

Evaluation of deficiencies in management's model, data or assumptions

- The auditor clearly demonstrated their evaluation of deficiencies identified in management's method, model or assumptions and appropriately supported their conclusion whether an internal control deficiency existed and whether it was considered a significant deficiency.
- Concerns were communicated in writing to the appropriate level of management or those charged with governance, depending on the significance of the deficiency identified.
- There was evidence that previous deficiencies identified were considered as part of the auditor's risk assessment.

[1] Examples are not intended to include all procedures that were performed by the engagement team but to highlight those procedures that in CPAB's view, contributed to the overall quality of the work performed to support accounting estimates with a significant level of estimation uncertainty.

- An auditor's expert was involved in the evaluation of deficiencies identified in management's estimation approach to support conclusions related to the impact on the evaluation of internal control. For example, sensitivities performed by the auditor's expert to demonstrate that the deficiencies in management's model, method or assumptions would not result in a material misstatement in the financial statements even if the circumstances of the reporting issuer or environment change.

Stand-back assessment included an evaluation of evidence obtained during the audit

- The auditor evaluated management's retrospective review of previous judgments and assumptions. The auditor's evaluation also considered the continued appropriateness of management's determination of cash generating units, understanding of the model, key assumptions and data used, and consideration of whether contradictory evidence existed.
- The auditor considered the impact of estimates used in other areas of the audit. For example, management's assumptions underlying the impairment model were consistent with the liquidity outlook for the next twelve months in the going concern assessment.

Looking ahead – role and mindset of professional accountants

Auditors must be alert to the subjectivity of accounting estimates, management bias and opportunities that increase the risk of fraud. Enhancing the firm's culture of professional skepticism will help auditors to assess the susceptibility of the accounting estimate to fraud. We strongly encourage Canadian firms to adopt the Role and Mindset Expected of Professional Accountants (formerly Professional Skepticism) issued by the International Ethics Standards Board for Accountants (IESBA) coming into effect December 31, 2021. The IAASB and IESBA have been working to modernize the auditing and independence standards, reflecting that the role and mindset of professional accountants is critical to complying with the CAS and to promoting a firm quality culture.

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