Accounting Estimates in Audit

Navigating Judgment, Uncertainty and Risk

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Workshop on Creating a Better Financial Reporting Ecosystem

Centre for Audit Quality Committee | ICAI | NFRA

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SESSION ROADMAP

What We Will Cover in the Next 60 Minutes

01

The Highest-Risk Frontier

Why estimates dominate audit risk under Ind AS

02

The SA 540 Architecture

A working flow from risk assessment to documentation

03

Professional Skepticism

Cognitive traps and the discipline of challenge

04

Indicators of Possible Management Bias

Understanding the indicators

05

The Regulator's Lens

QRB & NFRA observations

06

Q&A and Looking Ahead

Where standards and inspection focus are heading

The six estimates that majorly define modern audit risk:

ECL
Credit loss modelling under Ind AS 109

Impairment
CGU testing, recoverable amount

Useful Lives
Management judgement on asset life

Fair Values
Level 3 inputs, unobservable markets

Provisions
Probability-weighted future outflows

Defined Benefit Obligations
Actuarial assumptions, discount rates

We do not audit certainty. We audit the reasonableness of judgment under uncertainty.

PART 01

The Highest-Risk Frontier

THE HIGHEST-RISK FRONTIER

Every Line Item That Matters Is, At Some Level, An Estimate

Information Quality

Estimation Uncertainty

Misstatement Risk

Management Bias

The SA 540 logic (Para 2) recognises that the quality of information available to management directly determines how uncertain an estimate will be — which in turn drives both the risk of misstatement and the opportunity for bias.

THE HIGHEST-RISK FRONTIER

Not All Estimates Are Equal: The Uncertainty Spectrum

LOW UNCERTAINTY

- Simple, recurring provisions
- Observable inputs
- Recognised measurement techniques
- Short forecast periods

HIGH UNCERTAINTY

- Entity-developed fair value models
- Unobservable (Level 3) inputs
- Highly judgment-dependent assumptions
- Long forecast periods, scarce external data

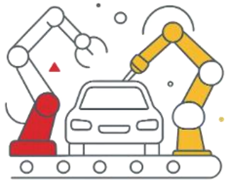
Judgment dependence

Sensitivity to assumption changes

Forecast horizon

Observable Inputs

The Spectrum in Practice: Four Estimates from Real Files



Warranty Provision — Auto Components

- 5 years of claims data
- 12-month window; formula-driven
- Analytics support the estimate
- Low uncertainty — recurring and observable

Gratuity (DBO) — Manufacturing Entity

- Observable discount rate
- the judgment hides in the **6% escalation assumption vs 9% actual increments.**
- Medium uncertainty — the actuary does not remove the auditor's responsibility.

ECL — NBFC Wholesale Loan Book

- Thin default data
- Staging and macro-overlays highly judgmental.
- **A significant risk** requiring dee independent challenge on every key input.

Level 3 Fair Value — Unlisted CCPS

- Entity-built DCF
- unobservable inputs
- **1% WACC move swings value ~15%**
- High uncertainty — the model's output is only as reliable as its weakest assumption.

PART 02

The SA 540 Architecture

SA 540 provides an 8-step framework for auditing estimates—understanding its purpose is key to robust evidence, not mere compliance.

Eight Steps from Risk Assessment to Documentation

1. **Understand** Methods, assumptions, data, controls, experts (Para 8)
2. **Look back** Retrospective review — a bias detector (Para 9)
3. **Assess risk** Estimation uncertainty; significant risks (Para 10–11)
4. **Respond** Test the process · controls · own estimate (Para 12–14)
5. **Go deeper** Alternative assumptions; intent & ability (Para 15–16)
6. **Set a range** Reasonable outcomes, within performance materiality (A93)
7. **Test disclosure** Disclosure can fail even if framework-compliant (Para 19–20)
8. **Hunt for bias** Bias indicators; document conclusions (Para 21, 23)

The framework is scalable — a recurring warranty provision does not warrant the same depth as a Level 3 valuation.

PART 03

Professional Skepticism

Not suspicion — the discipline of not being the last person in the room to ask an obvious question.

PROFESSIONAL SKEPTICISM

Four Cognitive Traps That Blunt the Challenge

Anchoring

Avoid validating management's estimate first; form an independent expectation to challenge, not confirm.

Confirmation Bias

Seek contradictory evidence, not just support; ignored contrary data creates significant audit risk.

Expert Deference

SA 620: Evaluate the expert's competence, objectivity, data, and conclusions—don't just file the report.

Complexity Surrender

Complexity is not a basis for trust; it demands greater professional challenge and skepticism.

The Four Questions on One Estimate: A Gratuity Obligation

The scenario: a manufacturer's gratuity obligation booked at ₹38 cr. The same four skepticism questions, applied to this one estimate.

Q1: What would have to be true for ₹38 cr to be right?

Salary escalation 6%, attrition 8%, discount rate 7.2%. Listed explicitly, the **6% escalation is the weakest link** — actual increments have run at 9% for two consecutive years.

Q2: What happened to last year's assumptions?

FY25 also assumed 6% escalation; actual increments came in at **9.1%.** Second year running — the pattern itself constitutes evidence of systematic optimism (Para 9).

Q3: Which assumption moves the number most?

Sensitivity: +1% escalation adds **₹2.6 cr** to the DBO; +1% discount rate reduces it by ₹2.1 cr. Escalation dominates — that is precisely where the challenge must be directed.

Q4: Why was 8% escalation rejected?

HR budgets 8–9%. Management's "normalisation" memo was tested and found unpersuasive. **Escalation revised; adjustment proposed** and carried to the Summary of Misstatements (Para 15).

Skepticism in Action: Questions That Earn Their Keep

Four questions to put to any significant estimate — applied to a real one on the next slide.

1	2
What would have to be true for this number to be right?	What did last year's estimate look like — against what actually happened?

3	4
Which single assumption moves this number the most?	Why did management reject the alternative assumptions?

PROFESSIONAL SKEPTICISM

The Same Four Traps — As They Appear on Real Files

The same four traps, each shown as it surfaces on a working paper.

Anchoring in Practice

The team tests management's 14% WACC — and concludes within 0.5% of the anchor. No independent build was performed. The file shows testing, not challenge.

Confirmation Bias in Practice

Broker notes supporting 6% growth are filed; consensus data at 3% never reaches the file. The evidence base is selectively assembled in management's favour.

Expert Deference in Practice

Actuary's certificate filed untested — the report assumes 2% attrition against the entity's own 11% historical experience (SA 620). No challenge was raised or documented.

Complexity Surrender in Practice

Vendor black-box ECL model: only the total figure was tied out. The staging logic — the most judgment-intensive component — was left entirely unchallenged.

PART 04

Indicators of Possible Management Bias

Understanding the indicators

Indicators of Possible Management Bias (SA 540, A125)

The specific indicators SA 540 (A125) names — signals to evaluate, not conclusions.

Convenient Changes

Estimate or method changed on a subjective claim that circumstances changed — without substantive evidence to support the change.

Off-Market Assumptions

Own assumptions for fair value that are inconsistent with observable market data — a significant indicator when the departure favours management.

Constructed Convenience

Assumptions constructed to yield a point estimate that is precisely favourable to management — a result that is rarely a coincidence.

Patterns Over Periods

A point estimate fitting a pattern of optimism or pessimism across multiple reporting periods — the retrospective review is the primary tool for detecting this.

⚠ Indicators are not misstatements — but each must be evaluated. Where there is intent to mislead, management bias is fraudulent in nature.

The Four Indicators

Convenient Changes

Useful lives extended from **15 to 20 years** as debt covenants tighten — the technical report post-dates the CFO's internal email requesting a review. The sequence matters.

Off-Market Assumptions

Investment carried at management's **40% CAGR growth assumption**; the entity's most recent funding round implies a valuation 30% lower. The market signal is directly contradictory.

Constructed Convenience

Terminal growth set at exactly **5.2%** — the precise rate at which VIU equals carrying amount. When a single assumption sits exactly at the breakeven point, it is rarely a coincidence.

Patterns Over Periods

A provision released every Q4 for **three consecutive years**, each time bridging the gap between reported results and analyst guidance. The pattern is itself evidence demanding evaluation.

Indicators identified must be evaluated for their implications for the overall audit response. The evaluation and its conclusion must be documented on the file.

The Auditor's Range: Reasonable, Not All Possible, Outcomes

Encompass Reasonable Outcomes

A93: A range of all possible outcomes is too broad; use only reasonable, evidence-supported outcomes.

Narrow to ≤ Performance Materiality

If the range cannot be narrowed within performance materiality, estimation uncertainty may be a significant risk, requiring enhanced audit response and disclosure (A93).

Outside the Range = Unsupported

A116: If management’s estimate falls outside the auditor’s range, a misstatement exists at least equal to the nearest boundary difference.

Key Principle

The auditor's range is not a comfort zone — it is a structured conclusion based on evidence. Management's estimate either falls within it, or a misstatement must be considered for the Summary of Misstatements.

Misstatement ≥ gap to nearest range boundary (A116)

The Range in Numbers: A CGU Impairment Test

The Setup

Cement CGU, carrying value **₹580 cr**; management's Value-in-Use **₹620 cr** — no impairment booked. The auditor must form an independent view.

The Auditor's Range

Applying market WACC of 13% and terminal growth of 4%, the auditor's reasonable range is **₹460–540 cr** — wider than performance materiality of ₹30 cr (A93). The breadth itself signals significant estimation uncertainty.

The Conclusion

Management's ₹620 cr sits **₹80 cr outside the range.** A misstatement of at least ₹80 cr follows (₹620 cr minus the nearest point of ₹540 cr). Impairment of not less than ₹50 cr must be recognised (A116).

When the Range Won’t Close: Escalation and Reporting

Insufficient Evidence → Modify

No basis or evidence = scope limitation → qualified opinion/disclaimer (SA 705). Uncertainty does not disappear into the SUM.

Communicate to TCWG

Qualitative aspects of estimates (assumptions, outcome range, bias indicators) must be reported to TCWG (SA 540.23; SA 260).

Stand Back and Conclude

Before sign-off, assess estimates against all evidence (including contradictory evidence) and conclude: reasonable or misstatement (SA 540 revised draft).

Key Principle

Not every estimate ends in a clean number. Three exits exist: an adjustment to the SUM, a communication to governance, or a modified opinion. The file must show which path was taken — and why.

Adjust · Communicate · Modify — SA 540 with SA 705 and SA 260

SA 540 CASE STUDY

ABC Fintech Ltd — The Valuation the Auditor Received

An unlisted fintech at Series B stage. The auditor receives the model the day before the board meeting.

The Entity

- Unlisted fintech, Series B stage
- Strategic investor acquisition pending
- Investment booked as Level 3 fair value in consolidated financial statements
- No comparable listed peer with identical business mix

The Valuation

- Expert-built DCF: ₹110 per share
- Projection horizon: 8 years
- WACC: 14% / Terminal growth: 5%
- Revenue CAGR assumed: 12% p.a.
- Margin ramp: 8% → 22% EBITDA

The Red Flags

- FY25 actual revenue missed budget by 18%
- FY26 model submitted unchanged
- Valuer: boutique firm, no prior engagement
- Sensitivity note: a single sentence
- Auditor received the model 24 hours before board sign-off

The auditor's task: not to re-do the valuation — but to obtain sufficient appropriate audit evidence that ₹110 is reasonable.

How the Auditor Actually Worked Through It

Not a checklist. A detailed audit — from an uncomfortable question to a defensible conclusion.

01 Something felt off

Understand · Look back · Assess risk

FY25 revenue missed by 18%. The FY26 model is unchanged. Every input is Level 3 — nothing observable to anchor on.

The auditor has a question before they have a procedure.

- Revenue missed by 18% — FY26 model identical
- All inputs Level 3: WACC, growth, margin ramp
- Estimation uncertainty: high

02 The auditor built their own view

Respond · Go deeper · Set a range

The auditor does not accept the model. They build an independent WACC, tie forecasts to the board-approved budget, and challenge the 12% CAGR against a 4% historical rate.

- Independent WACC built — management's rate inconsistent
- 12% CAGR challenged against 4% historical rate
- Auditor's range: ₹84–96 — ₹110 falls outside

03 Evidence documented and communicated

Test disclosure · Hunt for bias · Communicate

The ₹14 gap goes to the Audit Committee. The disclosure note is expanded. The bias check is documented — same optimistic forecast, three years running, cross-check rejected.

- Disclosure expanded: ±1% WACC moves value ~15%
- Bias documented: optimism pattern, cross-check rejected
- ₹14 gap reported to AC; named WRs obtained

What the Evidence Said

The eight steps did not re-do the valuation. They produced evidence. The evidence changed the outcome.

MANAGEMENT SAID

₹110

per share

"Reasonable.
Expert-supported.
Board approved."

WHAT THE AUDIT FOUND

Retrospective miss
FY25 revenue: 18% below forecast

Growth unsupported
12% CAGR assumed vs 4% achieved

Expert independence
Not established per SA 620

Discount rate
WACC inconsistent with market data

Disclosure
Level 3 sensitivity: a single sentence

Bias indicator
Same optimistic forecast — 3 years running

AUDITOR'S CONCLUSION

₹84 – 96

per share

Gap: ₹14 per share

- Communicated to Audit Committee (SA 260)
- Named WRs on WACC and growth rate (SA 580)
- Disclosure note expanded — sensitivity quantified
- Conclude on reporting

PART 05

The Regulator's Lens

Regulatory inspection findings on accounting estimates are consistent and instructive. Understanding the patterns helps practitioners anticipate the scrutiny and build files that survive it.

THE REGULATOR'S LENS

Recurring Observations — NFRA & QRB

01 Inflated Growth Rates

Not independently challenged by the engagement team

02 Management Expert Reliance

Work accepted without evaluation — observed across multiple firms

03 ROMM in Estimates

Risk of material misstatement not appropriately identified or assessed

04 Professional Scepticism

Not evidenced on the audit file

05 Management Bias

No review performed for indicators of bias in estimates

THE REGULATOR'S LENS

Recurring Observations — NFRA & QRB

06 Retrospective Review

Skipped — prior estimate accuracy not examined

07 Documentation Gaps

Significant risks insufficiently documented on file

08 Cash Flow Projections

Forecasts beyond five years accepted without justification

09 Estimation Uncertainty Disclosures

Inadequate or boilerplate — not entity-specific

10 Impairment Testing

Not presented to Audit Committee or Board for oversight

The regulator's lens tests the rigour, not the result.

Well-Audited, Proved Inaccurate

An estimate can turn out wrong yet remain entirely defensible — if the file demonstrates a rigorous challenge, sufficient appropriate evidence, and a reasoned conclusion at the time of sign-off.

"Correct", Poorly Audited

A number that happens to be right but is unsupported on the file is a finding. QRB and NFRA inspect the quality of audit evidence and process — not eventual outcomes.

Distinguish: "the estimate was wrong" vs "the audit of the estimate was deficient."

LOOKING AHEAD

The Regulatory Landscape and the Road Ahead

NFRA Audit Committee Interaction Series

NFRA Series 1: ECL (Ind AS 109)

NFRA Series 4: Impairment (Ind AS 36 & SA 540)

NFRA Series 5: Provisions (Ind AS 37 & SA 501)

Focus: Audit Committee questions and evidence expected in a well-audited file.

SA 540 (Revised) — Direction of Travel

ICAI ED SA 540 (Revised): Issued July 2023; aligned with ISA 540.

Introduces 3 risk factors: Complexity, Subjectivity, Estimation Uncertainty.

Requires scalable audit responses based on risk.
Stand-back evaluation already required (Paras 11 & 33).

Effective date in India: Yet to be notified.

Q & A

We will never make estimates certain. Our professional calling is to make the judgment behind them transparent, challenged, and defensible.

CA Abhijeet Bhagwat | Chartered Accountant

THANK YOU