ISA 540, *Auditing Accounting Estimates* – Issues and Task Force Recommendations

Objective of the Agenda Item

The objective of the agenda item is to obtain the Board's feedback on a draft revised "stand back" provision for proposed draft ISA 540 (Revised).

Introduction

1. The concept of a stand back provision is not new to the ISAs. For example, paragraph 26 of ISA 330[1] has a requirement for the auditor to conclude on whether sufficient appropriate audit evidence has been obtained. ISA 700 (Revised) also has a requirement for the auditor to make an evaluation regarding a number of specific matters, including whether the accounting estimates made by management are reasonable (see paragraph 13(c) of ISA 700 (Revised)).[2]

2. The ISA 540 Task Force's (the Task Force) outreach indicated that stakeholders are supportive of including a stand back requirement in ISA 540, recognizing that the iterative nature of the audit means that audit quality would be enhanced by requiring the auditor to take stock of the audit evidence obtained in relation to accounting estimates, particularly complex and challenging accounting estimates. In light of this, the Task Force has been exploring the addition of a more explicit "stand back" provision to ISA 540 for some months.

3. As explained to the IAASB at its September 2016 meeting, the stand back requirement is intended to drive the auditor to take into account all the evidence obtained, whether corroborative or contradictory, and conclude whether the auditor has sufficient appropriate audit evidence regarding accounting estimates. In response to the IAASB's input and the Task Force's deliberations, the Task Force has explored several iterations of how to integrate the ISA 540 stand back with the rest of ISA 540, and how best to articulate the requirement so that the linkage with the similar requirements in ISA 330 and ISA 700 (Revised) is clear.

4. The Task Force has explored several options at the June, September, and December 2016 IAASB meetings. At the IAASB's December meeting, the IAASB noted that the Task Force should:

   (a) Think further about whether the stand back provision in paragraph 13E should be performed for accounting estimates overall, or for individual accounting estimates;

   (b) Consider broadening the requirement so that it is based on the audit procedures performed in accordance with ISA 540 instead of just the work effort requirements;

   (c) Consider reinforcing the importance of professional skepticism in the requirement itself; and

   (d) Align the requirement more closely with other stand back provisions in the ISAs, such as that in ISA 330.

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[1] ISA 330, *The Auditor's Responses to Assessed Risks*

[2] ISA 700 (Revised), *Forming and Opinion and Reporting on Financial Statements*

Task Force Views on the Draft Provision

5. In considering the IAASB's comments, the Task Force noted a lack of clarity between the stand back provision in paragraph 13E of the draft discussed at the December 2016 IAASB meeting and the requirement in extant ISA 540 about evaluating whether the financial statements are reasonable in the context of the applicable financial reporting framework, or are misstated (see paragraph 18 of extant ISA 540). The Task Force believes that clearly distinguishing the two separate thoughts strengthens the requirement and aids clarity, and has accordingly broken up the requirement into paragraph 13E (which deals with the stand back provision) and paragraph 13F (which deals with whether the accounting estimates and related disclosures are misstated).

6. The proposed changes to the stand back provision are included in the **Appendix**. The main changes are:

   (a) The lead-in to paragraph 13 now makes explicit that this stand back provision is part of the ISA 330 stand back. It also indicates that the evaluation is based on all audit procedures performed in relation to accounting estimates, rather than the specific procedures done in accordance with the ISA 540 work effort.

   (b) Paragraphs 13E(a) and (b) from the December 2016 IAASB meeting papers have been collapsed into a single bullet (paragraph 13E(a)). This has removed redundant language and simplified the requirement.

   (c) Paragraph 13E(c) has been redrafted to better communicate the Task Force's intentions. That is, the auditor needs to evaluate whether sufficient appropriate audit evidence has been obtained about the matters in paragraphs 13A–13C, when applicable.

   (d) The final sentence of paragraph 13E has been relocated to the application material and modified to refer to possible implications on the auditor's report if the auditor is unable to obtain sufficient appropriate audit evidence (see paragraph AX5).

   (e) New paragraph 13F is based on former paragraph 13E(d). The Task Force determined that this paragraph needed to retain the reference to "reasonable" as this is a critical link to ISA 700 (Revised), paragraph 13(c). The Task Force will consider additional material to better explain the term "reasonable" in the context of ISA 540.

   (f) The Task Force has sought to better explain the purpose of the stand back provision better in paragraph AX1. Paragraph AX2 includes an example of how the stand back provision may interact with the ISA 540 work effort.

   (g) The Task Force has deleted some application material (paragraphs A121D–A121L and parts of paragraph A121C (renumbered as paragraph AX4)). There were a number of reasons for this:

      (i) Some material no longer fits well with the revised paragraphs 13E and 13F (see, for example, the deleted part of paragraph AX4 (formerly paragraph A121C), which may be better placed as application material to the new requirement on communications with those charged with governance) ;

      (ii) In other cases the Task Force reflected upon the comments at the December 2016 IAASB meeting that some of the application material was too lengthy, and did not provide much guidance to the auditor (see, for example, deleted paragraphs A121J–A121L). The

Task Force recognizes that some of this material may be reused elsewhere in the ISA as guidance for specific work effort provisions.

(iii) New application material has been added to provide guidance on specific issues that arose during the Task Force's outreach activities. These areas include when the audit evidence supports a point estimate that differs from management's point estimate, or a range that does not include management's point estimate (paragraph AX8). This paragraph also provides considerations for calculating the misstatement when the range does not include management's point estimate (paragraph AX8).

(h) Paragraph AX6 has been relocated to the top of the application material on paragraph 13F to highlight the linkage with ISA 450.

(i) In addition to changes to clarify the intent of existing material (paragraph A116 in extant ISA 540, now split over paragraphs AX7–AX8), the Task Force has also highlighted that the misstatement between management's point estimate and a range could be larger than the difference with the closest point of the range. This may be the case if, as appropriate in the context of the financial reporting framework, all points within the auditor's range are not of equal probability.

7. In response to other comments made by IAASB members, the stand back requirement was revised to refer to "accounting estimates" (plural). The Task Force considered comments from some IAASB members that the stand back relates to accounting estimates overall but, as a practical matter, the Task Force believes that this would be accomplished by considering individual accounting estimates.

8. The Task Force also considered including explicit reference to professional skepticism in paragraph 13E. On balance, the Task Force determined that including such a reference would put the focus on only those sentences where the term "professional skepticism" is used. The Task Force remains open to considering whether there is specific application material that could highlight how the requirement reinforces an attitude of professional skepticism.

Matter for IAASB Consideration

1. The IAASB is asked for its views on:

    (a) Paragraph 13E and paragraphs AX1–AX5; and

    (b) Paragraph 13F and paragraphs AX6–AX9.

2. The IAASB is also asked whether the application material is sufficient and appropriate to support the requirement, or whether more or different application material should be considered by the Task Force. For example, there may be suggestions for specific application material regarding professional skepticism or the calculation of misstatements for accounting estimates.

Appendix

Draft Stand Back Provision for ISA 540

Note to IAASB:

The paragraphs below have been marked to show changes from the December 2016 IAASB meeting agenda material.

Overall Evaluation Based on Audit Procedures Performed

13E. ~~Based on performing the audit procedures in paragraphs 13–13E, as applicable,~~In applying ISA 330,[3] the auditor shall evaluate, based on the audit procedures performed, whether sufficient appropriate audit evidence has been obtained ~~in respect of~~about the accounting estimates, including: (Ref: Para ~~A121B-A121L~~AX1–AX5)

(a) Whether management's decisions relating to the recognition, measurement, presentation and disclosure~~, or not,~~ of the accounting estimates in the financial statements are in accordance with the ~~requirements of the~~ applicable financial reporting framework and have been applied consistently applied; and

(b) ~~Whether management's methods for making the accounting estimates have appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimates, and have been applied consistently;~~

(c) In respect of the matters required to be addressed in accordance with paragraphs 13A–13C, as applicable.~~The assessed risks of material misstatement related to accounting estimates for which procedures under paragraphs 13A-13C were required; and~~

~~(d)~~ [Relocated to 13F]~~Whether the accounting estimates in the financial statements individually, or as a whole, are materially misstated, in the context of the applicable financial reporting framework A121M–A121P)~~

In evaluating the above matters, the auditor shall ~~take into account~~consider all relevant audit evidence, whether corroborative or contradictory.~~ If the auditor has not obtained sufficient appropriate audit evidence, the auditor shall attempt to obtain further audit evidence by performing additional audit procedures.~~

13F. [From 13E(d)] The auditor shall evaluate whether the accounting estimates and related disclosures are either misstated, or are reasonable in the context of the applicable financial reporting framework. (Ref: Para. A~~121M~~X6–AX9~~121P~~)

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[3] ISA 330, paragraphs 25 and 26

Note to IAASB:

The application material below has been renumbered for ease of reading and discussion. The numbering will be adjusted in due course to align with the numbering in ISA 540. The numbering from the December 2016 IAASB meeting papers is shown in ~~deleted text~~.

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 13E)

~~A121B.~~ AX1. ISA 330[4] notes that an audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. In relation to accounting estimates, information may particularly come to the auditor's attention through performing procedures to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable, that differs significantly from the information on which the risk assessment was based.

AX2. For example, the auditor may have identified that the reasons for an assessed risk of material misstatement are limited to the judgment used by management in making the accounting estimate. However, while performing procedures to address the matters in paragraph 13B, as applicable, the auditor discovers that the accounting estimate is more complex than was identified in the risk assessment phase, and therefore the reasons for the risk of material misstatement may include complexity. Therefore, the auditor may need to perform additional audit procedures to address the matters in paragraph 13A, as applicable. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.[5]

~~.~~AX3. ~~Where~~ When management has recognized and disclosed an accounting estimate in the financial statements, the focus of the auditor's evaluation ~~is on~~includes whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.

~~A121C~~AX4. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation ~~is~~may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. ~~Even where~~When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, ~~there may be a need for disclosure of the circumstances in the notes to the financial statements. Where applicable, the auditor may also determine that an accounting estimate that has been identified as having a high estimation uncertainty is a key audit matter to be communicated in the auditor's report in accordance with ISA 701,[6] or may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report (see ISA 706 (Revised)).[7] If the matter is determined to be a key audit matter, ISA 706 (Revised) prohibits the auditor from including an Emphasis of Matter paragraph in the auditor's report.[8]~~some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

AX5. If the auditor is unable to obtain sufficient appropriate audit evidence, this may constitute a limitation on the scope of the audit that may have implications for the auditor's report.

~~A121D. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures. Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting~~

~~framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.~~

~~A121E. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.~~

~~A121F. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.~~

~~A121G. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.~~

~~A121H. Areas where particular skills and knowledge may be required include:~~

- ~~Whether those involved in developing and applying the valuation technique have the appropriate skills and expertise to do so, including whether a management's expert has been used; and~~
- ~~Understanding the legal, regulatory, and tax implications resulting from the accounting estimate, including whether the contracts are enforceable by the entity (for example, reviewing the underlying contracts), may require specialized skills and knowledge.~~

~~A121I. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.~~

~~A121J. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.~~

~~A121K. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one particular model to another. Reacting to changes in market conditions may be difficult if management~~

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[4] ISA 330, paragraph A60

[5] ISA 315, paragraph 31

~~[6] ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*~~

~~[7] ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*~~

~~[8] ISA 706 (Revised), paragraph 8(b)~~

~~does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.~~

~~A121L. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.~~

Misstatements (Ref: Para.13F~~E(d)~~)

AX6. ISA 450[9] provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making identification of separate misstatements difficult or impossible.

~~A121M~~AX7. Based on the audit evidence obtained, the auditor may conclude that there is sufficient appropriate audit evidence supporting a point estimate that does not differ from management's point estimate, or a range that includes management's point estimate, which may lead the auditor to conclude that the accounting estimate is reasonable in the context of the applicable financial reporting framework~~the evidence points to an accounting estimate~~. [Further application material to be considered to address the concept of "reasonable" in this requirement, which would include taking into account the requirements of the applicable financial reporting framework to the extent that the framework addresses the matter.] ~~that differs from management's point estimate.~~

AX8. Alternatively, the audit evidence may support a point estimate that differs from management's point estimate, or a range that does not include management's point estimate. When the audit evidence supports an auditor's point estimate that differs from management's point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.

[9] ISA 450, *Evaluation of Misstatements Identified during the Audit*

When the audit evidence supports a range that does not encompass management's point estimate, the difference between management's point estimate and a point in the auditor's range is a misstatement. In such cases, the misstatement is not less than the difference between management's point estimate and the nearest point of the auditor's range, but could be greater if the audit evidence would best support an amount inside of the range.

~~Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is not less than the difference between management's point estimate and the nearest point of the auditor's range, but could be greater if, for example, the evidence supported a point estimate within the auditor's range.~~

~~A121N. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124–A125).~~

~~A121O. ISA 450[10] provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:~~

- ~~Misstatements about which there is no doubt (factual misstatements).~~
- ~~Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).~~
- ~~The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).~~

~~In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.~~

A~~121P~~X9. Evaluating whether sufficient appropriate audit evidence has been obtained, and whether the accounting estimate is misstated, for accounting estimates and related disclosures included in the notes to the financial statements~~, whether required by the applicable financial reporting framework or disclosed voluntarily,~~ involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.

~~[10] ISA 450, *Evaluation of Misstatements Identified during the Audit*~~