

REVISION OF ISA[™] 540, AUDITING ACCOUNTING ESTIMATES, INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED DISCLOSURES

This document was developed and approved by the IAASB. The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance.

The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

I. Subject

1. This project proposal addresses the revision of International Standard on Auditing[™] (ISA) 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

II. Background, Project Objectives, Scope, Focus and How The Project Serves the Public Interest

Background

2. The International Auditing and Assurance Standards Board[®] (IAASB[®]) consultations in developing its *Strategy for 2015–2019*¹ and related *Work Plan for 2015–2016* (the Work Plan)² indicated a need for the IAASB to take action to address issues relevant to financial institutions, as well as ISA 540 more broadly. As a result, the final Work Plan included plans for a project to address “special considerations relevant to financial institutions”, with a working group formed in 2015³ to commence the activities contemplated by the Work Plan. The Work Plan acknowledged that, as a result of the work on special considerations relevant to audits of financial institutions, the Working Group may identify a need for a broader revision of ISA 540 or recommend the development of International Auditing Practice Notes (IAPN[™]) or other non-authoritative guidance to address matters related to financial institutions.

¹ http://www.ifac.org/system/files/publications/files/IAASB-Strategy-2015-2019_0.pdf

² <http://www.ifac.org/system/files/publications/files/IAASB-Work-Plan-2015-2016.pdf>

³ The Working Group includes members with a diverse background, such as practitioners, banking and insurance regulators, and a national standard setter.

3. Since commencing its work in early 2015, the Working Group has undertaken significant outreach activities to identify issues involving audits of financial institutions to inform the development of a project proposal. The leadership of the Working Group and Staff has met with, amongst others, representatives of the Financial Stability Board, the United States Public Company Accounting Oversight Board (PCAOB), the International Association of Insurance Supervisors (IAIS) and the Basel Committee on Banking Supervision's (Basel Committee) Accounting Expert Group, and has also met several times with the Global Public Policy Committee's⁴ Banking IAASB Liaison Subgroup. The IAASB has received further input via letters from the IAIS⁵ and the Basel Committee,⁶ and has also discussed the International Forum of Independent Audit Regulators' (IFIAR) annual survey of inspection findings⁷ with the IFIAR Standards Coordination Working Group.
4. These outreach activities and the input received formed the basis of the Working Group's presentations at the March and June 2015 IAASB meetings. One of the key themes arising from the outreach activities was that regulators and auditors of financial institutions were of the view that the IAASB should focus on the issues for audits of financial institutions arising from the impending adoption of IFRS 9,⁸ (i.e., ahead of its effective date for financial statements for annual periods beginning on or after January 1, 2018) and a similar project conducted by the United States Financial Accounting Standards Board (FASB) that is due for completion soon. These standards adopt an expected credit loss model for loan loss provisions, which fundamentally changes the way that banks and other entities will account for their loan assets. Many stakeholders are therefore of the view that these changes will bring new and urgent challenges for management and the audit profession. To further inform the IAASB's considerations, the Working Group prepared a "gap analysis", the purpose of which was to determine whether extant ISA 540 was viewed as effective in addressing the audit issues arising from IFRS 9.

⁴ The GPPC comprises the six largest international accounting networks: BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG and PwC.

⁵ Amongst other matters, the IAIS highlighted the need for consideration of audit issues of particular relevance to insurers, in light of the accounting developments in this area and the significance of these changes to insurers. The IAIS cited certain ISAs as being particularly relevant to the audits of insurers, including ISA 540; ISA 570 (Revised), *Going Concern*; and ISA 620, *Using the Work of an Auditor's Expert*.

⁶ Amongst other matters, the Basel Committee has suggested that consideration should be given to the use of fair value accounting and related estimates by financial institutions, including but not limited to impairment and loan loss provisioning, as well as other ISAs particularly relevant to the audits of banks and other financial institutions, including International Standard on Quality Control 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*; ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*; ISA 260 (Revised), *Communication with Those Charged with Governance*; ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*; ISA 540, ISA 570 (Revised), and ISA 620. Some of the issues raised by the Basel Committee will be addressed more broadly by other projects, such as the Quality Control project and the ISA 315 project (which will commence its activities in 2016). The complete letter is available at http://www.iaasb.org/system/files/meetings/files/20150316-IAASB-Agenda_Item_5-B-BCBS%20Letter.pdf.

⁷ <https://www.ifiar.org/IFIAR/media/Documents/General/IFIAR%20Global%20Survey%20Media%20Coverage/IFIAR-2014-Survey-of-Inspection-Findings.pdf>

⁸ International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

5. This analysis was discussed by the IAASB and the IAASB Consultative Advisory Group (IAASB CAG) at their respective September 2015 meetings. The discussions in these meetings highlighted that most, if not all, of the issues identified would be equally relevant when auditing complex accounting estimates more generally and in particular for audits of all entities that will have to apply IFRS 9, rather than only financial institutions. Accordingly, it was concluded that a holistic revision of ISA 540 should be undertaken as a matter of priority, recognizing the importance of taking action to respond to the issues identified and, in particular, the importance of being responsive to concerns raised in relation to audits of financial institutions and other entities applying IFRS 9.
6. The Board also agreed that supplemental activities may be necessary in the future to address specific considerations in the audit of financial institutions, beyond those that will be addressed in the revision of ISA 540. This may include IAPNs, Staff publications, project updates or other materials addressing specific audit considerations related to financial institutions, the relationship between a financial institution's regulatory supervisor and its external auditor, or other specific guidance in relation to audits of financial institutions (such as IFRS 9, the International Accounting Standards Board's (IASB) proposed standard on insurance contracts (or similar standards under other financial reporting frameworks) or other specific topics).
7. The Appendix contains further background to the project, including from outreach, and the IAASB and IAASB CAG discussions, which were taken into account in developing the objectives and scope of this project proposal.

Project Objectives

8. The project objectives are to:
 - (i) Propose revisions to ISA 540, establishing more robust requirements and appropriately detailed guidance to foster audit quality by driving auditors to perform appropriate procedures in relation to accounting estimates and related disclosures. It is anticipated that these revisions would also seek to emphasize the importance of the appropriate application of professional skepticism when auditing accounting estimates.
 - (ii) Determine whether non-authoritative guidance and support tools, such as IAPNs,⁹ Staff publications,¹⁰ project updates or other materials, should be developed in the future to address special audit considerations relevant to financial institutions¹¹ to supplement the revisions to ISA 540 and oversee the development of the guidance material considered necessary.

⁹ IAPNs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

¹⁰ Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

¹¹ For the purpose of this project proposal, financial institutions include banks and insurance companies.

Project Scope

9. As evidenced by responses to the ISA Implementation Monitoring project,¹² the Work Plan, outreach conducted by the Working Group, and the discussions in meetings of the IAASB CAG and the IAASB, there are areas where there have been calls for clearer or additional requirements or guidance to enable auditors to appropriately deal with increasingly complex accounting estimates and related disclosures, including obtaining sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements as a whole.
10. Inspection finding reports from audit regulatory bodies highlighted consistent issues with respect to accounting estimates, including in relation to audits of financial institutions. Audit deficiencies identified related to the performance of sufficient risk assessment procedures; the extent of the auditor's understanding and further consideration of the appropriateness of methodologies used by management to determine fair values; and sufficiency of testing over the accuracy and completeness of data used and the reasonableness of assumptions adopted by management in making the accounting estimate, including the consideration of contradictory or inconsistent evidence, where available.
11. It will likely be necessary for the IAASB to develop new or revised requirements or expanded application material in ISA 540 in order to respond to the issues and concerns raised. The IAASB will also seek to make the intended application of the principles-based requirements in ISA 540 more clear, in particular in light of developments in accounting standards, the increasing complexity and need for management judgment in developing accounting estimates and challenges that are encountered in practice in relation to accounting estimates with high estimation uncertainty.
12. The IAASB acknowledges the importance of the involvement of auditor's experts in auditing certain complex accounting estimates, and will therefore consider whether ISA 540 addresses the use of auditor's experts appropriately and whether amendments to ISA 620 are necessary to more clearly address the need for the auditor to consider whether and when an auditor's expert should be involved. The IAASB will closely follow the PCAOB's projects on auditing estimates and fair value measurements¹³ and the use of the work of specialists,¹⁴ and consider if there are opportunities for the IAASB to benefit from the PCAOB's work on these topics. The IAASB's project to revise ISA 540

¹² In 2009, shortly after the clarified ISAs became effective, the Board embarked on a post-implementation review; which is referred to as the "ISA Implementation Monitoring project." This project focused on obtaining input from a variety of different channels to learn about adoption and implementation issues related to the clarified ISAs. The rigorous outreach program, in particular the strengthened collaboration with the IFIAR Standards Coordination Working Group, and the International Organization of Securities Commissions (IOSCO), as well as ongoing dialogue with audit firms, national auditing standard setters and others, continues to keep the IAASB apprised of areas where improvements to the IAASB's standards may be needed, or where other actions to enhance auditor performance may be appropriate. The findings of the outreach program resulted in the 2013 publication [Clarified International Standards on Auditing-Findings from the Post-Implementation Review](#).

¹³ On August 19, 2015, the PCAOB issued for public comment a staff consultation paper that seeks input on certain issues related to auditing accounting estimates and fair value measurements.

¹⁴ On May 28, 2015, the PCAOB issued for public comment a staff consultation paper that seeks input on potential changes to the PCAOB's standards for the auditor's use of the work of specialists, specifically the objectivity and oversight of specialists and the use of their work in audits. The IAASB response to the PCAOB's staff consultation paper is available at: <http://www.ifac.org/news-events/2015-08/iaasb-comments-pcaob-staff-consultation-paper-auditor-s-use-work-specialists>.

may also result in conforming or consequential amendments to other ISAs, including ISA 315 (Revised) and IAPN 1000.¹⁵

Considerations Relevant to Small- and Medium-Sized Entities (SMEs) and Small and Medium Practices (SMPs)

13. In developing a revised version of ISA 540, the IAASB will seek to minimize unnecessary consequences to audits of smaller entities and make the application of the standard more clear by, for example, differentiating the work effort on complex and non-complex estimates, (as many SMEs generally have fewer complex accounting estimates), or taking other steps to help auditors navigate the standard. In this regard, dialogue with International Federation of Accountants' (IFAC) SMP Committee and other relevant SMP stakeholders will be sought to obtain appropriate input at key stages of the project.

How the Project Serves the Public Interest

Enhancing the ISAs to Be Sufficient and Appropriate for the Evolving and Complex Business Environment of Today

14. Financial reporting frameworks are evolving, with greater use of complex accounting estimates, whether based on fair value measurements or otherwise, and which require significant management judgment in the face of high levels of estimation uncertainty. More forward-looking information is increasingly being used as the basis for recognition or measurement, or required to be disclosed in the financial statements. For example, IFRS 9 and other financial reporting standards require greater use of forward-looking information, including information regarding economic conditions external to the entity. In addition, as a result of the application of these new financial reporting standards, large parts of the statement of financial position are based on accounting estimates, with corresponding impacts on the statement of profit and loss and other comprehensive income. Disclosures regarding accounting estimates often need to explain the basis on which accounting estimates have been made and the key data inputs and assumptions. Accounting estimates and related disclosures are therefore a fundamental part of the financial statements for many entities and are continuing to become more prevalent as the requirements of applicable financial reporting frameworks continue to increasingly require their use.¹⁶
15. In light of the global financial crisis and the importance of financial institutions to global financial stability, there are increased expectations on auditors in relation to accounting estimates. Outreach activities by the Working Group, as well as audit inspection findings, have identified emerging issues in relation to accounting estimates that are developed using complex business processes. For example, the development of some accounting estimates requires extensive reliance on information technology systems and use of large volumes of system-generated data. Accounting estimates are

¹⁵ IAPN 1000, *Special Considerations in Auditing Financial Instruments*

¹⁶ In July 2015, the IAASB released revisions to the ISAs to address disclosures in an audit of financial statements. The objective of the project was (i) to focus auditors on addressing disclosures throughout the audit process to drive changes in the auditor's approach and improve consistency in practice to more specifically address disclosures, in particular qualitative disclosures, and (ii) Clarifying the auditor's work effort in relation to disclosures. The final pronouncements are available at: <http://www.ifac.org/publications-resources/addressing-disclosures-audit-financial-statements>.

also increasingly the result of complex models leading to the need for enhanced oversight by management and those charged with governance and improvements in internal control over financial reporting to ensure that the models are appropriate in the circumstances and that meaningful and relevant assumptions, and data, are used.

16. In light of the issues identified and the increasingly complex nature of certain accounting estimates in the financial statements, it is clearly in the public interest for the IAASB to consider whether it is necessary to strengthen the auditor's work effort with respect to accounting estimates, including the use of an auditor's expert when appropriate, so that users of the auditor's report can continue to have confidence in the auditor's opinion on the financial statements.
17. The IAASB intends to debate the issues and concerns that have been noted and consider what revisions will be necessary to ISA 540 to promote audit quality in the varied and complex scenarios that arise today, and that are likely to continue to evolve in the future. In particular, the IAASB will consider how specific requirements in ISA 540 could be further enhanced or clarified, to drive auditors to perform appropriate procedures relating to specific types of accounting estimates, taking into consideration the processes in place at the entity in developing the accounting estimates, and reinforcing the application of professional judgment and professional skepticism.¹⁷
18. The IAASB will also consider what guidance is needed for auditors to understand the various contexts in which ISA 540 can be applied – ranging from the most simple accounting estimates (for example, depreciation of tangible assets), to those that arise in environments where complex models or inputs are used (for example, financial instruments at level 3 of the fair value hierarchy). Further, auditors will benefit from guidance that addresses how to deal with challenges that may be encountered in practice, in particular in relation to:
 - Auditing accounting estimates with high estimation uncertainty;
 - Auditing accounting estimates developed using models that involve complex methodologies or multiple inputs with complex inter-relationships, or that use data from outside the traditional accounting system (such as historical data from internal business processes or subjective predictive inputs from external sources);
 - Auditing accounting estimates that need the involvement of management's or auditor's experts; and
 - How the auditor can approach the auditing of disclosures relating to specific accounting estimates.
19. The public interest would also be served by improving ISA 540 through:
 - Clarifying and strengthening the auditor's work effort on accounting estimates that give rise to a significant risk, including giving further consideration as to how the concepts of significant risk and accounting estimates with high estimation uncertainty are related; and

¹⁷ The IAASB has a project looking at professional skepticism more broadly. For details, see www.iaasb.org/projects/professional-skepticism.

- Including specific material addressing third-party pricing sources¹⁸ and governance over complex models used to generate accounting estimates.

Fostering an Appropriately Independent and Challenging Skeptical Mindset of the Auditor

20. Regulators and audit oversight bodies have highlighted concerns about how auditors are addressing accounting estimates, noting instances where professional skepticism does not appear to be appropriately applied. The IAASB commenced a project on professional skepticism in June 2015¹⁹ and, on an initial basis, is exploring what actions are relevant to enhance the application of professional skepticism via the December 2015 Invitation to Comment, *Enhancing Audit Quality in the Public Interest—A Focus on Quality Control, Group Audits and Professional Skepticism*.
21. In relation to accounting estimates, regulators and audit oversight bodies are calling for more robust requirements in the ISAs to encourage a skeptical mindset and to direct how the auditor obtains sufficient appropriate audit evidence in relation to significant accounting estimates, including more granularity relating to the auditor's evaluation of management's assumptions and consideration of indicators of management bias.
22. Revising ISA 540 therefore provides an opportunity to stress the importance of professional skepticism and its role in making professional judgments in relation to accounting estimates that are complex or have been identified as having high estimation uncertainty. These accounting estimates generally involve significant management judgment and, therefore, there may be increased management bias, whether intentional or unintentional. In this regard, consideration could be given as to how the requirements in ISA 540 are drafted, with a view to making amendments that focus on the auditor approaching accounting estimates with a more questioning mindset rather than one of corroboration. The revised standard could also more explicitly highlight the need to consider the effect of contradictory audit evidence that comes to the auditor's attention.

Communications, Interactions and Documentation, as well as Transparency

23. The IAASB recognizes the public interest importance of a two-way dialogue between the auditor and those charged with governance. The Board will therefore consider opportunities to further emphasize in ISA 540 the importance of and the need for effective auditor communications with those charged with governance about accounting estimates that are complex or have high estimation uncertainty, reporting on control deficiencies related to such accounting estimates and the effects of changes to financial reporting standards that require accounting estimates.
24. It may also be helpful for ISA 540 to highlight that communications during different phases of the audit between auditors and others (e.g., supervisors or other regulatory or oversight bodies) might be required or in the public interest.
25. In relation to auditor reporting, the requirements to communicate key audit matters for audits of financial statements for listed entities may also provide auditors with an opportunity to highlight

¹⁸ The Appendix contains further background on the IAASB's previous discussions related to third-party pricing sources in the context of the development of IAPN 1000.

¹⁹ More information about the IAASB's project on professional skepticism is available at: <http://www.iaasb.org/projects/professional-skepticism>.

matters relating to the auditing of complex accounting estimates. While ISA 701²⁰ already provides guidance to suggest that matters related to accounting estimates may be determined to be key audit matters, further guidance within ISA 540 may be considered appropriate.

26. The IAASB's work on the topic of quality control is exploring whether strengthening requirements for engagement quality control reviews would be useful in enhancing audit quality, for example by further specifying the nature and extent of matters to be considered by the engagement quality control reviewer and how this review is to be documented. In light of the greater use of accounting estimates and the increased need for significant management judgment, consideration of the responsibilities of the engagement quality control reviewer in this regard by the Quality Control Working Group will likely be necessary.

Outline of the Project

Major Issues that Will Be Addressed

27. Without pre-judging any matters that the project Task Force may bring to the IAASB for discussion in the project, the Working Group's preliminary assessment of the issues that will need to be dealt with in the revision of ISA 540 include the following.

Ensuring ISA 540, Including Its Requirements, Is "Fit for Purpose" in Light of Today's Evolving and Complex Business Environment

28. The ISA Implementation Monitoring noted issues around risk assessment procedures, and applying ISA 540 to certain accounting estimates, focusing on the work effort on management assumptions and the relationship between accounting estimates and significant risks. These issues were echoed by inspection findings and during the Working Group's outreach activities, which identified a view that ISA 540 does not provide much guidance on how to address particular types of accounting estimates – that is, those that use a number of different assumptions, data sources, and modelling requirements that occur in a complex business environment. The IAASB will also consider whether more guidance is needed to emphasize the importance of identifying and testing relevant controls when auditing accounting estimates that rely on large volumes of complex system-generated data (as it might be impractical or even impossible to only perform substantive procedures to address the risks of material misstatement related to such estimates).
29. The IAASB will explore whether more explicit guidance is needed to highlight the importance of the auditor's consideration of the need to involve auditor's experts in obtaining sufficient appropriate audit evidence, as auditing complex accounting estimates could require expertise in a field other than accounting or auditing. In some cases, third party data sources may be used by management, which, while not experts, provide information that is used as inputs to management's processes. ISA 540 could also be enhanced by including guidance on evaluating different views between experts, given the potential for different judgments producing large differences in estimates.
30. ISA 540 contains high-level requirements and guidance on how the auditor should assess data on which accounting estimates are based, including data that comes from systems that have traditionally not been part of the financial reporting process. However, it does not include guidance that

²⁰ ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report, paragraph 13

emphasizes the importance of testing controls around the data that comes from systems that have traditionally not been part of the financial reporting process. The IAASB will therefore consider whether additional guidance is necessary relating to the assessment of the sufficiency and appropriateness of data on which accounting estimates are based, including a focus on the need for identifying and testing relevant controls. As part of the IAASB's Disclosures project, requirements have been enhanced and new application has been added to ISA 315 (Revised), highlighting the need for attention, during the planning process, on information in disclosures that is obtained from outside of the general and subsidiary ledgers. The IAASB will consider whether further changes are needed to better align ISA 540 with ISA 315 (Revised) in this regard. This may include relevant learnings from the IAASB's project on data analytics.

31. The IAASB will also consider whether the guidance in ISA 540 on how the auditor addresses estimates that have an acceptable range that is multiple times performance materiality could be enhanced. Such large ranges can often result from only minor differences in assumptions, each of which may be subject to varying degrees of subjectivity.
32. The issues outlined in paragraphs 28–31, which have been evolving for some time, have received an increased focus due to the issuance of IFRS 9 by the IASB and a similar project conducted by the FASB. The IAASB realizes the need to consider these issues and will also investigate whether there are other issues and challenges posed by the evolving and increasingly complex business environment.

Addressing the Identification of Accounting Estimates that Give Rise to Significant Risks and Driving Appropriate Related Work Effort

33. In some industries, such as financial institutions or extractive industries, and organizations, there are certain aspects of accounting estimates that are particularly challenging as they are subject to a high level of estimation uncertainty or have other features that make them challenging to audit. Paragraph 11 of ISA 540 requires the auditor to determine whether, in the auditor's judgment, any of the accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks (which then require special audit consideration), but does not make a link with other factors included in ISA 315 (Revised) that the auditor can consider in the determination of whether an accounting estimate gives rise to a significant risk. The IAASB will explore whether a stronger correlation can be made in ISA 540 between other features of accounting estimates and the determination as to whether any of those features gives rise to a significant risk. The IAASB will also consider whether additional guidance is necessary to help auditors better understand the sources and characteristics of high estimation uncertainty.
34. As an accounting estimate that gives rise to one or more significant risks will often be a focus area for both auditors and users of financial statements, the IAASB will consider whether it is necessary to provide greater specificity in the requirements related to the design of the auditor's response to such risks, in addition to the requirements that already exist in paragraphs 15–17 of ISA 540. The IAASB will also explore whether changes to ISA 540 are needed to highlight the importance of testing the operating effectiveness of controls for estimates that give rise to a significant risk(s). These

controls often involve significant complexity and levels of judgment. As a result, these types of controls are challenging to test and are a focus area of audit regulatory bodies.

Addressing the Use of Third-Party Pricing Sources by Auditors and Management

35. In the development of IAPN 1000,²¹ the IAASB noted the increasing use of third-party pricing sources in the valuation of financial instruments. As a result, IAPN 1000 includes additional background and educational material addressing how third-party pricing sources may be used by auditors and management, as well as further material on related audit considerations such as the use of experts. The IAASB also acknowledged that amendments to ISA 500²² and ISA 540 may be needed to clarify the distinction between a third-party pricing source and a management's expert, as defined in ISA 500. In addition, there may be merit in clarifying the related auditing considerations in light of the relevant material contained in IAPN 1000, with a view to potentially further enhancing the ISAs themselves.

Emphasizing Appropriate Application of Professional Skepticism Relating to Accounting Estimates and Related Disclosures

36. Professional skepticism is defined in the ISAs²³ as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.” Exercising professional skepticism throughout the audit is particularly important for accounting estimates that are complex or have been identified as having high estimation uncertainty, including when the range of possible outcomes for the accounting estimate is multiples of performance materiality. In these areas, it is expected that the auditor should have a questioning mind when reviewing the judgments and decisions made by management in making accounting estimates, including consideration of relevant controls and related disclosures, in order to identify whether there are indicators of possible management bias. As recognized by the Professional Skepticism Working Group in its June 2015 paper,²⁴ standard setting alone is not enough to enhance the application of professional skepticism, as professional skepticism “has a psychological dimension that makes the concept complex, and addressing it difficult. However, emphasizing professional skepticism through requirements and guidance could help the auditor in more effectively challenging management's judgments.”
37. Inspection findings and outreach conducted by the Working Group highlighted that the guidance in ISA 540 could be clearer to aid all parties, including firms and regulators, in understanding the standard's intent as it relates to challenging the reasonableness of assumptions adopted by management in making the accounting estimate, including the consideration of contrary or inconsistent evidence, where available. Therefore, there may be a need to address challenging

²¹ See paragraphs 29–32 of the Basis for Conclusions on IAPN 1000, http://www.iaasb.org/system/files/publications/files/Basis%20for%20Conclusions%20-%20IAPN%201000%20%20Final_0.pdf

²² ISA 500, *Audit Evidence*

²³ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, requirement 13

²⁴ http://www.iaasb.org/system/files/meetings/files/20150617-iaasb-agenda_item_10-a_professional_skepticism_issues-for-review-final.pdf

management's assumptions and possible management bias more clearly in the requirements and application material of ISA 540 (and potentially providing a greater linkage between ISA 540 and ISA 240),²⁵ as this could further reinforce the application of professional skepticism which would likely lead to higher quality audits. Further consideration may also be needed on the audit procedures to be applied to underlying data (including data from third-party pricing sources, service organizations and management's experts), and the definition of management bias. In this regard, the Task Force will work together with the Professional Skepticism Working Group to consider how the concept of professional skepticism could be reinforced in ISA 540.

Improving the Audit Focus on Disclosures Related to Accounting Estimates

38. Disclosures are a fundamental part of the financial statements, and are seen as an increasingly important way for preparers to communicate about the entity and its financial position and financial performance. In the IAASB's recently completed Disclosures project, requirements and application material in various ISAs were enhanced to drive changes in the auditor's approach with respect to disclosures, improve consistency in auditor performance to more specifically address disclosures, in particular qualitative disclosures, and clarify the auditor's work effort in relation to disclosures. Disclosures are of particular importance when dealing with accounting estimates with high estimation uncertainty, as disclosures regarding such accounting estimates are critical to users' understanding of that estimation uncertainty. As such, it is in the public interest that the IAASB contributes to enhancing the credibility and usefulness of financial reporting disclosures related to accounting estimates by assessing whether additional guidance may be needed in ISA 540 (and other ISAs) to assist auditors in considering the adequacy of those disclosures (e.g., in respect of estimation uncertainty).

Addressing Audit Considerations Specific to Financial Institutions

39. As noted in the Work Plan and confirmed by the Working Group's outreach, it is likely that guidance would be useful to further explain how certain of the Board's International Standards are applied in the context of an audit of a financial institution. Throughout the process to revise ISA 540, the Working Group will continue its information-gathering activities related to audit considerations relevant to financial institutions, and consideration will be given to whether the development of additional specific guidance for the audits of financial institutions is necessary to complement the revision of ISA 540.
40. For example, outreach with financial institution regulatory supervisors and practitioners has highlighted the importance and benefits of the dialogue between the external auditor and the supervisor during the auditor's risk assessment, while performing the audit procedures, and at the completion of the audit. The supervisor may be able to provide the auditor with relevant information about the banking or insurance industry in its jurisdiction, while the auditor could share its insights from the audit. In 2014, the Basel Committee issued guidance²⁶ on the dialogue between the external auditor and the bank's regulatory supervisor and insurance supervisors are considering something similar for the insurance industry. While IAPN 1000 contains guidance on the topic, the IAASB will

²⁵ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

²⁶ In March 2014, the Basel Committee issued the document [External Audits of Banks](#). Section B of Part 1 describes the relationship between the financial institution's regulatory supervisor and the external auditor.

consider whether more specific guidance, for example through additional application material within ISA 540 or another IAPN,²⁷ would be useful in this regard to highlight the discussions that could be held (or may be required) between auditors and supervisors. The information shared in this two-way dialogue, or three-way if the audited entity is also represented, could potentially improve audit quality and the oversight of financial institutions and therefore serve the public interest.

Impact Analysis Considerations

41. The primary expected benefit of this project is an increase in audit quality through more robust requirements and appropriately detailed guidance to drive auditors to perform appropriate procedures when auditing accounting estimates and related disclosures. Regardless of whether the outcome of this project results in new or revised requirements and guidance, there may be implications for the cost of the audit. This is because it is likely that the project will provide an additional focus on the risk assessment and an increased work effort related to certain accounting estimates. It is anticipated that the impact on cost would vary depending on the size and complexity of the entity and other entity-specific factors; the IAASB will specifically consider the effect on SMPs. While audit costs may increase for certain entities, providing enhanced and consistent guidance on accounting estimates for auditors would be expected to result in higher audit quality, which is in the public interest.

III. Implications for Any Specific Persons or Groups

42. The project has implications for all participants in the financial reporting supply chain, but particularly for auditors who perform audits of financial statements in which the use of accounting estimates is prevalent.
43. Depending on the nature of the proposals, there may be fewer implications for audits of SMEs, as these entities generally have fewer (complex) accounting estimates. However, as the ISAs apply to all entities, the risk of unintended consequences to audits of smaller entities needs to be considered. In addition to other outreach,²⁸ IFAC's SMP Committee will be kept apprised of developments to ensure appropriate input is received at key stages of the project.
44. The project also has implications for, and linkages with, other IAASB initiatives, including work on the topics of Quality Control, Professional Skepticism, Data Analytics and ISA 315 (Revised).
45. Users of the financial statements have highlighted interest in accounting estimates that are complex or have been identified as having high estimation uncertainty.²⁹ This project may have implications for users by highlighting the benefits of transparency about accounting estimates through the communication of key audit matters in accordance with ISA 701 in the auditor's report.

²⁷ The Appendix contains an overview of the background to IAASB pronouncements in this area.

²⁸ The IAASB will continue its dialogue with stakeholders such as the IFIAR's Standards Coordination Working Group, IOSCO, European Audit Inspection Group, the Forum of Firms, Global Public Policy Committee's Banking IAASB Liaison Subgroup, IAIS and Basel Committee.

²⁹ ISA 701, paragraph A24

IV. Development Process, Project Timetable and Project Output

Development Process and Project Timetable

46. The project will be conducted in accordance with IFAC’s Standards-Setting Public Interest Activity Committees’ Due Process and Working Procedures.³⁰
47. Subject to the IAASB’s approval of the ISA 540 project proposal, the project to revise ISA 540 will commence immediately. The IAASB proposes the following preliminary timetable, noting that specific project milestones and outputs may change as the project develops.

Timing	Action
December 2015	Teleconference to obtain the IAASB CAG’s input on project proposal
	IAASB approval of project proposal and consideration of specific issues
March 2016 – September 2016	Obtain input from the IAASB CAG on the issues and proposals, including an exposure draft of revised ISA 540 (including possible revisions or conforming amendments to other ISAs)
	IAASB deliberation of issues, proposals and draft versions of the exposure draft. This includes consideration of whether additional pronouncements, such as IAPNs, are necessary to address specific issues
	Consideration of any relevant feedback from the IAASB’s December 2015 Invitation to Comment, <i>Enhancing Audit Quality in the Public Interest—A Focus on Quality Control, Group Audits and Professional Skepticism</i> , and related IAASB outreach activities
	Dialogue with stakeholders on key issues and proposals ³¹
December 2016	IAASB approval of exposure draft, with a 120-day comment period, including possible conforming amendments to other ISAs
2017	Obtain IAASB CAG input on consideration of the responses to the exposure draft and proposed changes to ISA 540 (Revised) as a result of those responses
	IAASB deliberation of responses to the exposure draft and resulting proposed changes to ISA 540 (Revised)
Q4 2017	IAASB approval of ISA 540 (Revised)

³⁰ https://www.ifac.org/system/files/uploads/PIAC-Due_Process_and_Working_Procedures.pdf

³¹ This timeline also acknowledges the possibility that the IASB may issue its new Insurance Contracts standard in the first half of 2016, which would require further consideration by the Task Force and IAASB.

Project Output

48. The expected output of the project is a revised ISA 540, with possible revisions, or conforming amendments, to other ISAs and IAPN 1000 as necessary. The IAASB will consider whether material from IAPN 1000 can be included in ISA 540, as appropriate.
49. The Task Force will, throughout the revision of ISA 540, also consider and advise the IAASB as to the need for, and potential timing of, development of other non-authoritative guidance, in the form of an IAPN, Staff publication, project update or other material. Such non-authoritative guidance may, for example, address specific audit considerations related to financial institutions, the relationship between the financial institution's regulatory supervisor and the external auditor, or specific guidance in relation to accounting estimates in accordance with IFRS 9 or the IASB's proposed standard on insurance contracts (or similar standards under other financial reporting frameworks). Where possible, the IAASB will first consider whether new guidance could be included within ISA 540 (Revised) in relation to certain issues particularly relevant to financial institutions, without unduly burdening the standard. Doing so could provide useful "hooks" for any additional guidance that could be developed in the future.
50. Related to this project proposal, in early 2016, the proposed ISA 540 Task Force intends to issue a publication / project update that:
 - Explains the public interest issues that are driving the IAASB's actions related to accounting estimates and specifically expected credit losses;
 - Alerts auditors and other interested parties to audit issues arising from IFRS 9 related to expected credit losses;
 - Highlights how the ISAs and IAPN 1000 may already address audit issues related to expected credit losses, points out areas of focus for the auditor and, for certain issues related to accounting estimates, signals preliminary views of the Task Force on what action the Board may need to consider; and
 - Provides an overview of the IAASB's intentions to revise ISA 540 and potentially issue IAPNs or other forms of guidance.

The proposed Task Force may periodically publish a revised version of the project update to inform stakeholders about the evolving discussions and views of the Task Force in respect to the matters listed above.

V. Resources Required

51. The IAASB proposes establishing a project Task Force to be responsible for the project to revise ISA 540. It is envisaged that many of the current members of the Financial Institutions Working Group will become members of the proposed ISA 540 Task Force. The proposed Task Force is expected to consist of approximately 11 individuals, including IAASB members with diverse backgrounds, representatives from the Basel Committee and the IAIS, and external members. The Chair and the Co-Chair of the proposed Task Force would both be IAASB members.
52. IAASB Staff will provide support to the ISA 540 Task Force.

Background and Relevant Developments

History of the Standard

1. The auditing standard that preceded ISA 540 was issued in October 1987. This standard was codified and reissued as ISA 540, *Audit of Accounting Estimates*, in November 1993. ISA 545, *Auditing Fair Value Measurements and Disclosures*, was issued in June 2002 and was effective for audits of financial statements for periods ending on or after December 31, 2003
2. In September 2006, the IAASB approved a revised version of ISA 540, *Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)*. After approval, the IAASB agreed that ISA 540 was to be redrafted in accordance with the IAASB's Clarity conventions. Also, the IAASB determined that ISA 545 should be incorporated into ISA 540 in order to form one combined ISA dealing with accounting estimates, including fair value accounting estimates. In December 2007, the IAASB approved the combined standard, which replaced the previous versions of ISA 540 and ISA 545 and also voted to withdraw ISA 545 for periods beginning on or after December 15, 2009.
3. Matters addressed in the application and other explanatory material of ISA 540 were influenced by the changes occurring in the credit markets in late 2007 just prior to the finalization of the ISA. At the end of 2008, the IAASB released an IAASB Staff Audit Practice Alert³² to highlight areas within the ISAs that are particularly relevant to fair value accounting estimates in times of market uncertainty, including related issues regarding uncertainty as to an entity's ability to continue as a going concern.³³ Notwithstanding these initiatives, the IAASB anticipated that given emerging economic developments at the time, there would be a need for further practical guidance to be developed to address auditing fair value accounting estimates associated with complex financial instruments.

Additional Guidance

4. In June 2009, the IAASB commenced a project to revise International Auditing Practice Statement (IAPS) 1012³⁴ to address emerging economic developments at that time and to update IAPS 1012 for the revisions to ISA 540. IAPS 1012 provided guidance to the auditor in planning and performing auditing procedures for financial statement assertions related to derivative financial instruments, focusing on derivatives held by end users, including banks and other financial sector entities. However, since its release in 2001, the landscape in which audits of derivative financial instruments were conducted had changed, as had the ISAs themselves, and the use of fair value accounting had

³² The Staff Audit Practice Alert, *Challenges in Auditing Fair Value Accounting Estimates in the Current Market Environment*, is available at www.ifac.org/sites/default/files/downloads/Staff_Audit_Practice_Alert.pdf.

³³ The Staff Audit Practice Alert, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, is available at <https://www.ifac.org/publications-resources/staff-audit-practice-alert-audit-considerations-respect-going-concern-current>.

³⁴ IAPS 1012, *Auditing Derivative Financial Instruments*

become more prevalent. The IAASB also recognized that the economic environment resulting from the global financial crisis, which gave rise to issues in relation to valuations and to financial statement disclosures about risks and uncertainties pertaining to financial instruments, would likely continue to prove challenging for both preparers and auditors.

5. In October 2009, the IAASB issued a Consultation Paper with respect to revising IAPS 1012. Responses to the Consultation Paper indicated strong support for the direction being considered by the IAASB. The feedback obtained on identified topics of interest was used to inform the IAASB's development of a new guidance document which was approved, as IAPN 1000, in September 2011. Notwithstanding that the IAPN included some guidance on an entity's use of a third party pricing source, at the time of approving the IAPN, the IAASB acknowledged that amendments to the application material in ISA 500 and 540 may be needed relative to an entity's use of third party pricing sources. The IAASB considered proposing limited amendments for this purpose, but ultimately concluded that such amendments should be considered more holistically with other aspects of IAPN 1000 that may warrant inclusion in the ISAs.³⁵
6. At its September 2011 meeting, the IAASB also decided to withdraw the existing category of non-authoritative pronouncements known as IAPs as they were largely out of date and inconsistent with the text of the clarified ISAs, and to establish a new category of non-authoritative documents—IAPNs. Among other IAPs, IAPS 1004, *The Relationship between Banking Supervisors and Banks' External Auditors* and IAPS 1006, *Audits of the Financial Statements of Banks* were withdrawn.
7. In its *Strategy and Work Program, 2012–2014*,³⁶ the IAASB identified initiatives to explore certain issues related to accounting estimates and related considerations (including third party pricing sources) and to determine whether guidance would be useful regarding the relationship between the financial institution's regulatory supervisor and the external auditor. Work on these topics did not however substantively commence, due to the IAASB's decision to instead make auditor reporting a priority focus. Therefore, the IAASB included in its Consultation Paper on the *Strategy for 2015–2019* and related the Work Plan special audit considerations relevant to financial institutions, which includes the exploration of issues related to accounting estimates, as a priority topic.

³⁵ http://www.iaasb.org/system/files/publications/files/Basis%20for%20Conclusions%20-%20IAPN%201000%20%20Final_0.pdf

³⁶ <http://www.ifac.org/system/files/publications/files/IAASB%20Strategy%20and%20Work%20Program%202012-2014-final.pdf>

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