

## *ISA 540 (Revised) and Related Conforming and Consequential Amendments*

This summary provides an overview of the changes that the International Auditing and Assurance Standards Board (IAASB) made to ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming and consequential amendments.

**Project Objectives:**

The objectives of the project were to:

- Revise ISA 540 to establish 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. These revisions would also emphasize the importance of the appropriate application of professional skepticism when auditing accounting estimates.
- Determine whether non-authoritative guidance and support tools, such as International Auditing Practice Notes, Staff publications, project updates or other materials, should be developed.

**Effective Date:**

Audits of financial statements for periods beginning on or after December 15, 2019.

**For More Information:**

Visit the IAASB's website at [www.iaasb.org](http://www.iaasb.org).

## Why change the IAASB's standard on auditing accounting estimates?

Changes to financial reporting standards have increased the importance and visibility of accounting estimates to users of financial statements. The previous version of ISA 540 was written before recent changes in accounting for expected credit losses and revised standards dealing with insurance contracts, revenue recognition and leases. These changes, along with recurring audit inspection findings criticizing the quality of audits of accounting estimates, led to the need for the IAASB to address this challenging area to improve audit quality.

### What are the public interest issues addressed in the revision of ISA 540?

ISA 540 (Revised) addresses the following public interest issues:

- **Audit risks are evolving due to a more complex business environment** – Financial reporting frameworks continue to evolve, management judgment and forward-looking information is becoming more prevalent, and disclosures continue to grow in importance. Financial regulators have concerns about the complex business processes, which rely on technology, and the need to test the operating effectiveness of controls when auditing accounting estimates.
- **Fostering improved exercise of professional skepticism** – Findings by audit inspectors have raised significant concerns about audit quality for accounting estimates, and a need to address this by fostering a more independent and challenging skeptical mindset in auditors.
- **Realizing public interest benefits through improved communication and transparency** – Governance, reporting and regulation may be enhanced through improved two-way dialogue between the auditor and those charged with governance about complex estimates and those with high estimation uncertainty. Further, communication with regulators or prudential supervisors, and communication of Key Audit Matters in accordance with ISA 701, may be warranted in certain circumstances.



## What are the key enhancements to the IAASB standard on auditing accounting estimates?

The increasingly complex business environment and change in accounting practices means that auditors need a more robust approach to identifying, assessing and responding to risks of material misstatement for accounting estimates and related disclosures. The enhancements in ISA 540 (Revised) are aimed at keeping pace with the changing market.

### Key enhancements

The IAASB has made the following key enhancements to ISA 540 (Revised):

- Explicitly recognized the **spectrum of inherent risk** (paragraph 4), building on existing concepts in ISA 200, ISA 315 (Revised), and ISA 330, to drive scalability.
- Introduced the concept of **inherent risk factors**, including not only estimation uncertainty but also complexity, subjectivity and others (paragraphs 2, 4, and 16).
- Enhanced **risk assessment** procedures relating to obtaining an understanding of the entity and its environment, including the entity's internal control (paragraph 13).
- Introduced a **separate assessment of inherent risk and control risk** for accounting estimates (paragraph 16).
- Emphasized the importance of the auditor's decisions about **controls** relating to accounting estimates by highlighting relevant requirements in ISA 315 (Revised) and ISA 330 (paragraphs 19 and 20).
- Introduced **objectives-based work effort** requirements directed to methods (including specifically when complex modelling is involved), data and assumptions, to design and perform further audit procedures to respond to assessed risks of material misstatement (paragraphs 7, 19, 22-25).
- Enhanced the "**stand back**" requirement, by adding an evaluation of the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence (paragraphs 33–35).
- Enhanced **disclosure** requirements to obtain audit evidence about whether the related disclosures are "reasonable" (paragraphs 26(b), 29(b) and 31).
- Included a new requirement to consider matters regarding accounting estimates when **communicating with those charged with governance** (paragraph 38).
- New and enhanced **application material**.
- With respect to **external information sources**, conforming and consequential amendments to the definitions, requirements and application material in ISA 500.

## How does ISA 540 (Revised) enhance the auditor's exercise of professional skepticism and how is it scalable?

Inspection findings raised significant concerns about audit quality for accounting estimates, and a need to address this by fostering a more independent and challenging skeptical mindset. ISA 540 (Revised) includes several key elements that are designed to enhance the auditor's application of professional skepticism.

The IAASB acknowledges the importance of a scalable standard for all types of accounting estimates, from those that are relatively simple to those that are complex, and included several elements to address this.

### How does ISA 540 (Revised) enhance the auditor's exercise of professional skepticism?

The IAASB recognizes the central role that professional skepticism plays in auditing accounting estimates. Therefore, ISA 540 (Revised) contains several provisions that are designed to enhance the auditor's application of professional skepticism, including:

- A requirement to design and **perform further audit procedures in a manner that is not biased** towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (paragraph 18).
- A **requirement to "stand back"** and evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence (paragraphs 33–35).
- Use of **stronger language**, such as "challenge", "question" and "reconsider", to reinforce the importance of exercising professional skepticism (see, for example, paragraphs A60, A95, and A135).

### How is ISA 540 (Revised) scalable?

The scalability of ISA 540 (Revised) is provided by:

- Introducing and emphasizing the **spectrum of inherent risk concept** (paragraph 4). Under the spectrum of inherent risk concept, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale.
- Including **specific paragraphs in the application material that demonstrate how ISA 540 (Revised) is scalable** in the risk assessment (paragraphs A20-A22) and the responses to the assessed risks of material misstatement (paragraph A84).
- Emphasizing a requirement that **the auditor's further audit procedures need to be responsive to the reasons for the assessment of the risks of material misstatement** at the assertion level and that the auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be (paragraph 18).

## How does ISA 540 (Revised) take into account inherent risk factors?

The risk assessment is a critical part of every audit. ISA 540 (Revised) includes an enhanced risk assessment specifically tailored to accounting estimates that builds on the risk assessment required by ISA 315 (Revised).

The inherent risk factors of estimation uncertainty, complexity and subjectivity play a central role in the revised risk assessment and throughout ISA 540 (Revised).

ISA 540 (Revised) also notes that there may be other inherent risk factors, including susceptibility to misstatement due to management bias or fraud.

### What are inherent risk factors?

Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls.

### Which inherent risk factors should the auditor take into account?

In the identification and assessment of the risks of material misstatement, extant ISA 540 focused on estimation uncertainty. ISA 540 (Revised) acknowledges that there may be other inherent risk factors and requires the auditor to take into account:

- Estimation uncertainty;
- Complexity; and
- Subjectivity.

#### *Estimation Uncertainty*

Estimation uncertainty is the susceptibility to an inherent lack of precision in the measurement of an accounting estimate.

#### *Complexity*

Complexity refers to the complexity inherent in the process of making an accounting estimate, such as when multiple data sets or assumptions are required.

#### *Subjectivity*

Subjectivity arises from inherent limitations in the knowledge or data reasonably available about valuation attributes.

## What has changed regarding the testing of accounting estimates?

ISA 540 (Revised) includes an enhanced work effort that addresses the challenges that auditors face by providing more guidance and objective-based requirements that are allow for scalability in the nature, timing and extent of procedures performed in relation to the degree of estimation uncertainty and the assessed risks of material misstatement..

### How have the procedures to obtain audit evidence changed?

As in extant ISA 540, the auditor's response to assessed risks include one or more **testing strategies**:

- Obtaining audit evidence from events occurring up to the date of the auditor's report;
- Testing how management made the accounting estimate; or
- Developing an auditor's point estimate or range.

For these testing strategies, the IAASB introduced **objective-based requirements**, directed to methods (including models), assumptions and data. The objective-based requirements allow scalability in the nature, timing and extent of the procedures performed, recognizing that the higher the assessed risks of material misstatement, the more persuasive the audit evidence needs to be.

### How is control testing emphasized?

Given the importance of testing controls around complex accounting estimates, particularly for financial institutions, the IAASB decided that ISA

540 (Revised) should emphasize the importance of the auditor's decisions about controls relating to accounting estimates. This is supported by a new requirement to separately assess control risk and by re-emphasizing the requirement in ISA 330 to test controls for significant risks in the current period if the auditor plans to rely on those controls (paragraph 20). The ISA also re-emphasizes the requirement in ISA 330 regarding when testing the operating effectiveness of controls is required (paragraph 19).

### What has the IAASB done to address the use of external information sources?

Given that external information sources (and management's experts) may be used when making accounting estimates, ISA 540 (Revised) cross refers to the relevant requirements in ISA 500.

The IAASB also made conforming and consequential amendments to ISA 500 to increase the focus on external information sources. The additions include a definition of an external information source and application material addressing audit evidence considerations related to external information sources.

## Activities to promote awareness, understanding and effective implementation

The IAASB is committed to supporting the implementation of ISA 540 (Revised) and related amendments recognizing the importance of the effective auditing of accounting estimates to the public interest.

Efforts to support effective implementation of the standard will focus on promoting awareness, informing and educating users about the changes, and opening a dialogue to learn about the experiences of those responsible for adopting and implementing the standard.

### ISA 540 (Revised) Toolkit

The IAASB will develop a separate section on its website to facilitate access to the resources aimed at promoting awareness, understanding and effective implementation of ISA 540 (Revised). In addition to the final standard and related conforming and consequential amendments, the toolkit also includes a staff-prepared [Basis for Conclusions](#) explaining the IAASB's rationale for its decisions to finalize ISA 540 (Revised).

During 2018 and 2019, publications and additional resources will be developed to explain various aspects or key topics, which may include:

- Examples to illustrate how the requirements in ISA 540 (Revised) are scalable for different entities with accounting estimates with different characteristics;
- An explanation of the range of different types of measurement bases that may be relevant in making an accounting estimate and how the measurement basis is applied in making an accounting estimate and related disclosures;
- Slide presentations to support educational activities;

- Flowcharts;
- Webcasts and podcasts; and
- Answers to frequently asked questions.

### Post-implementation review

The IAASB intends to undertake a post-implementation review at an appropriate time following the effective date of ISA 540 (Revised) to see if the revised standard has achieved its intended objectives and to assist the IAASB in:

- Understanding whether the standard is sufficiently scalable and whether it enhances the exercise of professional skepticism;
- Identifying implementation challenges and possible areas for improvement within the standard; and
- Considering whether further enhancements to ISA 540 (Revised) are necessary.

The post-implementation review may also identify how practical challenges and concerns are being addressed by auditors, management and audit committees.