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**Basis for Conclusions: ISA 540  
(Revised), Auditing Accounting  
Estimates and Related  
Disclosures (Other than those  
Involving Fair Value  
Measurements and Disclosures)**

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Assurance Standards Board*



**International Federation  
of Accountants**

**BASIS FOR CONCLUSIONS:  
CLOSE OFF DOCUMENT – ISA 540 (REVISED),  
AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES  
(OTHER THAN THOSE INVOLVING FAIR VALUE MEASUREMENTS AND  
DISCLOSURES)**

In September 2006, the International Auditing and Assurance Standards Board (IAASB) agreed the conventions to be used by the IAASB in drafting future International Standards on Auditing (ISAs). These conventions are commonly referred to as the IAASB's Clarity conventions.

Exposure drafts of certain proposed ISAs were issued before these new conventions were finalized. For these proposed ISAs, the IAASB is following a process whereby the exposure draft is revised to reflect changes considered necessary by IAASB as a result of the responses to the consultation. The revised ISA is described as the "close-off" document, and represents the final ISA that IAASB would have published had the drafting conventions not been changed as a result of the IAASB's Clarity Project. The Clarity conventions and necessary redrafting are then applied to the close-off document to arrive at a revised ISA that is exposed for comment on the Clarity changes only (unless in any particular case there is a specific issue on which further consultation (in effect re-exposure) is deemed necessary).

This Basis for Conclusions explains the more significant issues raised by respondents on the exposure draft of the proposed ISA 540 (Revised) (as drafted following IAASB's current drafting conventions) issued in December 2004, and how the IAASB addressed them. It has been prepared by staff of the IAASB and does not form part of ISA 540 (Revised).

## **Background**

1. The IAASB approved a project to revise extant ISA 540, "Audit of Accounting Estimates" in June 2002. In undertaking this project, the IAASB took account of the findings from the work undertaken by the Auditing Practices Board in the United Kingdom on aggressive earnings management which highlighted the audit of accounting estimates as an important consideration in dealing with that issue.
2. The IAASB issued an exposure draft of proposed ISA 540 (Revised) ("ED-ISA 540") in December 2004, with a comment date of April 30, 2005. The IAASB received forty-eight comment letters from a variety of respondents, including regulators, IFAC member bodies, and firms. The IAASB revised ED-ISA 540 as a result of these comments.

## **Structure of ED-ISA 540**

3. The IAASB attributed many of the comments on ED-ISA 540 to the fact that respondents were confused by the flow of the document. It was not clear to several respondents how the requirements build upon, or are to be applied in relation to, the requirements of ISA 315, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement" and ISA 330, "The Auditor's Procedures in Response to Assessed Risks."
4. The IAASB concluded that the understandability of ISA 540 (Revised) would be enhanced by aligning its structure more closely with that of ISAs 315 and 330.

5. Specifically, the IAASB combined in one section the auditor's responses to assessed risks of material misstatement, and made clear the incremental nature of the requirements relating to significant risks. Further, the IAASB grouped or consolidated, where appropriate, guidance relating to specific topics, or made clear where such guidance is discussed in ISA 540 (Revised) through greater use of headings and cross references.
6. The IAASB also accepted the point made by a few respondents that ED-ISA 540 appears to omit guidance on the auditor's identification and assessment of risks of material misstatement other than significant risks, an important aspect of the auditor's responsibilities under ISA 315. Accordingly, paragraphs 33-34 were added to ISA 540 (Revised) to address further the application of the related requirements of ISA 315 to the audit of accounting estimates.

### **Balance Between Discussion of Management's Responsibilities and the Auditor's (Paragraphs 11(c)(iv) and 42 of ISA 540 (Revised))**

7. A few respondents were of the view that ED-ISA 540 did not present an appropriate balance between discussion of management's responsibilities for making accounting estimates and the auditor's responsibilities. The IAASB accepted this point and, accordingly, it reviewed ED-ISA 540 with this particular consideration in mind. The IAASB concluded that ISA 540 (Revised) needs to specify further actions of the auditor to ensure that the audit addresses adequately those consideration necessary in light of the nature of accounting estimates and the general circumstances in which they are made.
8. In particular, the IAASB agreed that ISA 540 (Revised) should require the auditor, based on the assessed risks of material misstatement, to determine whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate (paragraph 42(a) of ISA 540 (Revised)). This was considered important in light of the complexity of the requirements in some financial reporting frameworks with respect to the accounting for, and disclosures of, some accounting estimates, the need for management to apply judgment in their application, and the potential for misapplication or differing interpretations.
9. In addition, the IAASB noted that ED-ISA 540 introduced the idea that a change by management, without good reason, in an accounting estimate from period to period may constitute a misstatement. However, it did so only by reference to changes to the relative location of the accounting estimate within management's range from the prior period. The IAASB concluded that the principal issue is whether the methods for making the accounting estimates have been applied consistently, and the appropriateness of the basis for changes, if any, in accounting estimates from the prior period. Accordingly, it agreed that ISA 540 (Revised) should require the auditor:
  - To obtain an understanding of whether, and if so why, there has been a change from the prior period in the methods of making the accounting estimates, as part of the required risk assessment procedures (paragraph 11(c)(iv) of ISA 540 (Revised)); and
  - Based on the assessed risks of material misstatement, to determine whether the methods for making the accounting estimates have been applied consistently, and the

basis for changes, if any, in accounting estimates from the prior period (paragraph 42(b) of ISA 540 (Revised)).

10. The IAASB also reviewed and revised the application and other explanatory material of ISA 540 (Revised) as appropriate. For example, as suggested by a few respondents, the guidance relating to the auditor's understanding of how management identifies the need to make accounting estimates in the financial statements was amplified to make clear that the auditor also had a responsibility to consider the completeness of accounting estimates (paragraph 18 of ISA 540 (Revised)).
11. The IAASB also considered the need to establish a requirement for the auditor to communicate matters relating to significant accounting estimates to those charged with governance, as suggested by a few respondents. The IAASB concluded that the responsibility of the auditor to communicate to those charged with governance is addressed adequately in proposed revised ISA 260, "Communications with Those Charged with Governance," and that there does not appear to be any particular matter requiring further amplification of the requirements and guidance in ISA 260 in the context of the audit of accounting estimates.

### **Events Occurring Up to the Date of the Auditor's Report (Paragraph 46(a) of ISA 540 (Revised))**

12. For accounting estimates that have been assessed as having risks of material misstatement, paragraph 28 of ED-ISA 540 required the auditor to determine whether events occurring up to the date of the auditor's report confirm, or contradict, the accounting estimate. Several respondents questioned the emphasis placed on this procedure, noting that in many cases, audit evidence from such events does not always confirm or contradict an accounting estimate, but may only lead to additional information about that estimate. Further, some respondents noted that it could be interpreted as being the primary procedure to be carried out by the auditor, with the other responses to the assessed risks of material misstatements applied only when there are no such events.
13. The IAASB accepted these points and concluded that it would be more appropriate to include this procedure as one of the optional responses that could be undertaken, individually or in combination, to respond to the assessed risks of material misstatement, rather than as a separate requirement (paragraph 46(a) of ISA 540 (Revised)). The IAASB also agreed that additional guidance should be provided explaining the circumstances where this procedure may be effective, and how it relates to the requirements of ISA 560, "Subsequent Events" (paragraphs 48-52 of ISA 540 (Revised)).

### **The Auditor's Use of Ranges and Point Estimates (Paragraphs 46(d) and 82 of ISA 540 (Revised))**

14. Paragraph 30(c) of ED-ISA 540 provided for the auditor to make, or use an expert to make, an independent estimate for comparison with management's accounting estimate. For significant risks where management has not applied a sensitivity analysis or considered alternative outcomes, paragraph 54 of ED-ISA 540 required the auditor to consider whether it is practical to develop a reasonable range of outcomes with which to

evaluate the reasonableness of management's point estimate. Many respondents expressed concern over how the use of ranges and independent estimates were described in ED-ISA 540. In particular, they were of the view that ED-ISA 540 does not adequately reflect how these techniques are used in practice. Nor does it make clear when either or both are expected to be considered by the auditor, and how they fit into overall iterative process of auditing an accounting estimate.

15. The IAASB accepted these points. It concluded that the process of auditing an accounting estimate, and the situations where either the development of an independent estimate or a range, or both, is appropriate, are such that ISA 540 (Revised) should not attempt to assign separate roles to these audit techniques, nor circumscribe their use based on whether a significant risk exists. Further, the IAASB is of the view that the auditor's consideration of the use of ranges is likely to form an integral part of the auditor's iterative decision-making process when considering whether to develop an independent estimate for comparison with management's point estimate. Accordingly, the IAASB concluded that it would be appropriate to revised ISA 540 (Revised) as follows:
  - To expand paragraph 30(c) of ED-ISA 540 to allow the auditor to develop either a point estimate or a range, as appropriate in the circumstances (paragraph 46(d) of ISA 540 (Revised)).
  - To explain the circumstances which may affect the ability of the auditor to apply one technique rather than the other (paragraph 65-67 of ISA 540 (Revised)).
  - To consolidate and reposition the guidance relating to the auditor's development of a range (paragraphs 68-71).
16. With respect to paragraph 54 of ED-ISA 540, respondents also noted that the wording of the requirement appears to imply that the auditor is obliged to resolve the shortfalls of management. The requirement was therefore seen as unbalanced with respect to the respective responsibilities of the auditor and management, and potentially unduly onerous. Further, it was also observed that ED-ISA 540 omits guidance in relation to when it may be considered "practicable" for the auditor to consider developing a range.
17. It was not the intention of the IAASB to suggest that the auditor perform work that is essentially a management task. Accordingly, in light of respondents' comments, the IAASB agreed that it would be useful to provide additional guidance on the interaction between management and the auditor. However, the IAASB reconfirmed its view that, in order to be able to conclude on the reasonableness of the estimate, the auditor needs to consider the potential effect of estimation uncertainty on the accounting estimates that give risk to significant risks where, in the auditor's judgment, management has not adequately addressed such effects. The IAASB did not accept the view of some respondents that this requirement is unduly onerous. The IAASB is of the view that the requirement, as amended, is appropriate in those limited circumstances where the stated conditions exist (paragraph 82 of ISA 540 (Revised)).
18. The IAASB agreed that the phrase 'where practicable' in paragraph 54 of ED-ISA 540 is ambiguous. Accordingly, it reworded the requirement such that the auditor is required to consider whether it is necessary to develop a range, and provided additional guidance

explaining the circumstances where the auditor may consider it necessary to do so (paragraph 83 of ISA 540 (Revised)).

**Defining a Sufficiently Narrow Range of Reasonable Outcomes (Paragraphs 72-73 of ISA 540 (Revised))**

19. Many respondents expressed concern over how the process of narrowing a range by the auditor was described in paragraphs 54-55 of ED-ISA 540. They called for a more understandable (and less technical) description, and noted that the term “reasonable range of outcomes” introduced in paragraph 54 may be problematic. Some respondents also noted that there is no guidance for situations where the narrowed range is greater than materiality.
20. The IAASB accepted these points. It concluded that ISA 540 (Revised) should refer to the range developed by the auditor for use in evaluating the reasonableness of management’s point estimate as “the auditor’s range,” and should describe the necessary characteristics of such a range for audit purposes. It also agreed to revise the definition of a narrow range to avoid terminology that may give rise to confusion or overlap with accounting terminology (paragraph 72 of ISA 540 (Revised)).
21. The IAASB also agreed that additional guidance explaining the relationship between a narrowed range and materiality should be provided in ISA 540 (Revised). It concluded that ordinarily a range that has been narrowed to be equal to or less than the amount lower than materiality determined for purposes of assessing risks and designing further audit procedures is adequate for purposes of evaluating the reasonableness of management’s point estimate. It agreed, however, that it would not be appropriate to require ranges to be no greater than such an amount. This acknowledges the fact that there may be circumstances, particularly in certain industries, where it is not possible to do so because of the magnitude of the accounting estimate in relation to the financial statements as a whole and the estimation uncertainty inherent in such estimates. This fact, however, does not necessarily preclude recognition of the estimate nor does it indicate that the outcomes are not reasonable where management’s inputs are based on a reasonable evaluation of significant and valid alternative assumptions. Rather, the IAASB agreed that it would be useful in such circumstances for the auditor to consider whether in such cases the recognition criteria and disclosure requirements of the financial reporting framework have in fact been addressed appropriately (paragraph 73 of ISA 540 (Revised)).

**Changes in the Relative Location of the Accounting Estimate Within Management’s Range for Period to Period**

22. Paragraphs 72-73 of ED-ISA 540 explained that changes by management, without good reason, to the relative location of the accounting estimate within management’s range from the prior period are to be treated as misstatements. Some respondents were of the view that if the applicable financial reporting framework does not provide guidance on determining point estimates from within the range of outcomes, the auditor is not in a position to conclude that there is a misstatement. Respondents also noted that the

guidance on a change in the location of an estimate within a range as a misstatement presumes that management develops a range, and that the auditor is aware of such range.

23. The IAASB agreed that the reference to the relative location within a range is secondary to the auditor's consideration of whether a change from a prior period is based on a change in the facts and circumstances affecting the accounting estimate, or is arbitrary. Accordingly, it was removed from ISA 540 (Revised).

### **Management's Consideration of Alternative Assumptions and Outcomes (Paragraph 76(a) of ISA 540 (Revised))**

24. For accounting estimates that give rise to significant risks, paragraph 48(b) of ED-ISA 540 required the auditor to evaluate whether and how management has considered alternative assumptions or outcomes, and why they have rejected them. A few respondents were of the view that it is not appropriate for the IAASB to suggest one method in which management addresses the effect of estimation uncertainty, or to presume management's ability to do so particularly in the context of a smaller entity. Respondents also noted that the requirement in paragraph 54 of ED-ISA 540 reinforces further the impression that management needs to apply the specified technique.
25. The IAASB reconfirmed its view that for significant risks, the auditor's work effort needs to focus on how management has addressed the effects of estimation uncertainty, and that the consideration of alternative assumptions and outcomes is ordinarily the primary way in which that is done. The IAASB did not intend, however, to prescribe a specific method and, accordingly, it revised the requirement and related guidance to clarify that it is whether management has assessed how estimation uncertainty may affect the accounting estimate and the adequacy of that assessment that are important, not the specific manner it is done (paragraphs 76 (a) and 77-81 of ISA 540 (Revised)).

### **Concluding on the Reasonableness of Accounting Estimates that Give Rise to Significant Risks**

26. For accounting estimates that give rise to significant risks, paragraph 60 of ED-ISA 540 required the auditor to consider the implications for the auditor's report where management does not perform further work requested by the auditor, or fails to consider information that is reasonably available to it. A few respondents noted that the requirement is unclear in its intent and application. They questioned whether there would be an effect on the auditor's report if the auditor obtains sufficient appropriate audit evidence, irrespective of whether management had, or had not, adequately supported the accounting estimate. The IAASB accepted this point and accordingly, removed the proposed requirement.

### **Disclosures of Estimation Uncertainty (Paragraph 90 of ISA 540 (Revised))**

27. Paragraph 70 of ED-ISA 540 required the auditor, for accounting estimates that fall within a reasonable range of outcomes that is greater than materiality, to determine whether the applicable financial reporting framework requires disclosure of the estimation uncertainty and, if so, to evaluate the adequacy of such disclosure. A few

respondents were of the view that the auditor should have a general responsibility to consider the adequacy of disclosures regarding estimation uncertainty, irrespective of its relationship to materiality.

28. The IAASB concluded that emphasis on the adequacy of disclosure is appropriate in light of accounting estimates that have high estimation uncertainty, which in most cases should relate to an assessed significant risk. The requirement was clarified to make this clear, with the related guidance explaining that the auditor's evaluation of the adequacy of disclosure increases in importance the greater the auditor's range is in relation to materiality. The IAASB noted that no further change was required in light of the requirement in paragraph 94 of ISA 540 (Revised) for the auditor to evaluate, based on the audit evidence, whether the accounting estimates and related disclosure are reasonable, in the context of the applicable financial reporting framework.

### **Misstatements**

29. Paragraphs 68-71 of ED-ISA 540 explained the treatment as misstatements of differences involving subjective judgments where there is a difference between the auditor's point estimate or range and management's point estimate. Respondents expressed concern about the general notion that the auditor is capable of developing a point estimate that is more precise than management's point estimate, and the treatment of the difference between as a misstatement.
30. The IAASB concluded that there may be cases when the auditor can conclude that the audit evidence indicates a point estimate that differs from management's, and accordingly a misstatement exists. Treatment of such differences as a misstatement does not supplant management's judgments but rather represents a valid, reasonable difference of opinion. The IAASB accepted the point, however, that such cases are likely to be rare, other than where there has been a factual error such as an incorrect calculation. ISA 540 (Revised) was amended to make this clear (paragraphs 74 and 94).

### **Indicators of Possible Management Bias**

31. Paragraph 75 of ED-ISA 540 required the auditor to consider whether there are indicators of possible management bias in the making of individual accounting estimates. In general, there was broad support by respondents for the IAASB to establish requirements and guidance for the auditor in relation to possible management bias. However, several respondents were concerned that ED-ISA 540 did not adequately explain the concept of management bias, including the different types of indicators of possible management bias, and the auditor's consideration thereof throughout the process of auditing accounting estimates. Nor did it explain how the auditor is expected to respond to circumstances where indicators have been identified as being present. Some respondents were also of the view that the wording of the requirement is ambiguous or passive with respect to the action expected of the auditor.
32. The IAASB accepted these points and agreed that greater emphasis on the auditor's consideration of indicators of possible management bias throughout the process of auditing accounting estimates would be useful in identifying and assessing risks and in

designing and implementing appropriate response. It therefore introduced additional guidance in ISA 540 (Revised):

- Describing the nature of management bias, including the fact that indicators of possible management bias identified during the audit of the preceding periods may influence the planning and risk identification and assessment activities of the auditor in the current period (paragraphs 8-9).
  - Explaining that the auditor’s review of the outcome of re-estimation of accounting estimates from the prior period may assist in identifying circumstances that increase the susceptibility of an accounting estimate to, or indicate the presence of, possible management bias (paragraph 29).
  - Directing the auditor to consider, in assessing the risks of material misstatement, the degree of estimation uncertainty and susceptibility to bias (paragraph 33).
  - Clarifying that the presence of indicators of possible management bias may affect the auditor’s conclusion as to whether the auditor’s risk assessment and related responses remain appropriate, and that the auditor may need to consider the implications for the rest of the audit (paragraph 99).
33. The IAASB concluded that, for purposes of ISA 540 (Revised), the auditor’s responsibility for the determination of indicators of possible management bias should not extend to concluding whether management bias exists and if so, determining whether it represents a misstatement. The auditor’s responsibility at the assertion level is to conclude whether, based on audit evidence, an accounting estimate and related disclosures are reasonable. Management bias is often neither apparent nor easily quantifiable at the assertion level or in relation to individual estimates – it is only when indicators of bias are aggregated, and taken account of along with other qualitative factors, that the auditor is in a position to evaluate the effect of bias on the financial statements. This is a matter addressed more appropriately in ISA 450, “Evaluation of Misstatements Identified During the Audit.”
34. The IAASB also agreed, in response to comments received:
- To reword the requirement in paragraph 75 of ED-ISA 540 to state that the auditor is required to determine (rather than consider) whether there are indicators of possible management bias (paragraph 99 of ISA 540 (Revised)); and
  - To replace the example in paragraph 77 of ED-ISA 540 with a more extensive list of examples of indicators of possible bias (paragraph 101 of ISA 540 (Revised)).

### **Considerations in the Audit of Smaller Entities**

35. Several respondents expressed concerned about the applicability of the some of the requirements of ED-ISA 540 to audits of smaller entities, and the extent to which the document provides guidance on the application of the requirements in the context of an audit of such entities.

36. The IAASB concluded that the requirements of ISA 540 (Revised), as amended in response to other concerns raised by respondents, are appropriate for audits of entities of all sizes. This conclusion was made in light of the fact that ISA 540 (Revised) accommodates alternative approaches to the audit of accounting estimates, depending on the circumstances, and generally does not prescribe one specific approach. The IAASB believes that the required procedures are appropriate in light of the nature of the varying risks associated with accounting estimates, which exist and therefore needs to be appropriately addressed irrespective of the size of the entity.
37. The IAASB accepted the point that additional guidance explaining the application of the requirement in the context of smaller entities would be useful and therefore introduced additional relevant explanatory material accordingly (paragraphs 6, 17, 24, 49, 55 and 81 of ISA 540 (Revised)).

### **Accounting Estimates and the Audit of Fair Value Measurements and Disclosures**

38. Several respondents questioned whether it is necessary or desirable to have two separate ISAs on auditing accounting estimates (ISA 540) and fair values (ISA 545, “Auditing Fair Value Measurements and Disclosures). The prevailing view of respondents was that the ISAs should be combined or amalgamated.
39. The IAASB agreed in principle that the relationship and overlap between ISAs 540 (Revised) and 545 needs to be considered further. It concluded, however, that this matter should be addressed as part of its Clarity project when ISA 540 (Revised) is redrafted in accordance with the new conventions adopted by the IAASB and considered in light of the structure and interrelationships of the ISAs.



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