

ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures – Issues and Task Force’s Recommendations

Introduction

Background

1. The origins of this project lie in the IAASB’s Work Plan 2015–2016.¹ The IAASB assembled a Working Group to commence initial work on the special considerations in the audit of financial institutions (that is, banks and insurers). The original intention was that the IAASB would learn from this exercise and a project to revise International Standard on Auditing (ISA) 540 would follow, now fully informed of many of the more complex accounting estimate issues that arise in financial institutions and the perspectives of key stakeholders. The IAASB discussed issues related this initiative in March, June, and September 2015, and the IAASB Consultative Advisory Group (CAG) discussed the initiative in September 2015.
2. In response to representations by the Basel Committee on Banking Supervision’s Accounting Experts Group, the Working Group noted that there was an urgent and immediate need for guidance on IFRS 9,² particularly for financial institutions.
3. In September 2015, the IAASB decided that, rather than focusing on financial institutions first, the Working Group should instead focus on revising ISA 540 more broadly. This was because the IAASB saw that making significant progress on the special audit considerations for financial institutions, and providing material related to IFRS 9, would be difficult without concurrently revising ISA 540. This larger project was given priority and allocated additional staff, ISA 540 Task Force (the Task Force) members, and resources.
4. The project proposal to revise ISA 540 was approved at the IAASB’s December 2015 meeting. In the subsequent 9 months, the Task Force has:
 - Drafted and released a project publication to specifically address the audit implications of IFRS 9, particularly regarding the adoption of expected credit loss accounting. This publication, while non-authoritative, provided the IAASB’s views on the emerging issues around the adoption of IFRS 9, and expected credit loss accounting more broadly (including some references to the Financial Accounting Standards Board’s (at the time) forthcoming Current Expected Credit Loss model). It also highlighted the likely direction of the project to revise ISA 540 so that auditors, regulators and other stakeholders could begin to adjust their thinking to the new approach.
 - Conducted over 20 outreach activities with stakeholders including regulators, auditors, financial institutions, and other types of entities.
 - Had six physical Task Force meetings and numerous teleconferences to progress issues.
5. As was acknowledged when the project proposal was approved, the Task Force’s intention is to ask the IAASB to approve an exposure draft (ED) in December 2016. This is an accelerated timetable

¹ International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

² www.ifac.org/system/files/publications/files/IAASB-ISA-540-Project-Publication.pdf

and represents a significant commitment by the IAASB to attempt to issue a final revised ISA 540 to coincide with the effective date of IFRS 9.

The Task Force's Approach to Drafting Proposed Revised ISA 540

6. Due to the rapid pace of Task Force discussions, the Task Force has focused on the most critical issues within ISA 540. These issues were determined based on the extensive outreach conducted for this project – which gives the Task Force confidence that the right issues are being addressed. Nothing in the outreach indicated that the ISA required a complete rewrite, however the various issues touch upon almost all areas of the ISA.
7. The Task Force has come to a consensus on many aspects of the ISA. Other areas of the ISA are still being explored and the responses received on the proposals presented in these papers are critical to the Task Force being able to finalize the ISA in accordance with the planned approval of the ED. The level of Task Force engagement and consensus on each area is described in the relevant sections below. The Task Force acknowledges that there is still work to be done to achieve consistent language and terminology throughout the ISA, resolve some key issues (particularly regarding the work effort) and reorganize and adjust the application material.
8. **Agenda Item E-2** shows marked changes from extant ISA 540. **Agenda Item E-3** is a clean version of the same document. The discussion will follow **Agenda Item E-2**.

Structure of this Paper

9. This paper is organized as follows:
 - Section I: Introduction to ISA 540, including Scalability of the ISA
 - Section II: Objective and Definitions
 - Section III: Risk Assessment
 - Section IV: Work Effort
 - Section V: Other Matters, Including Amendments to Other ISAs

Section I – Introduction to ISA 540, including the Scalability of the ISA

10. Only limited changes have been made to the introductory paragraphs of ISA 540 to align with minor wording changes related to the definition of an accounting estimate (see Section II below). Changes have also been made in view of the Task Force's recommendation to focus the auditor's work on accounting estimates according to three factors (estimation uncertainty, complexity, and judgment) instead of just estimation uncertainty as is the case in extant ISA 540.
11. The Task Force has also continued to refine how the ISA deals with lower risk accounting estimates. Noting the calls for greater specificity in various aspects of the ISA by some stakeholders, there is a perception that a revised ISA with more detailed requirements may be unreasonably burdensome on audits that only have accounting estimates that give rise to lower risks of material misstatement (such as may be common for depreciation, doubtful debts of trade debtors etc.). Outreach with the International Federation of Accountants' Small and Medium Practices (SMP) Committee, and discussions in the June 2016 Board meeting, highlighted the importance of scalability of ISA 540 for SMPs. The IAASB asked the Task Force to explore ways to be more specific about which aspects of the ISA do not apply to such accounting estimates.

12. The Task Force considered a number of ways to address this concern. The Task Force noted that it is not possible to make broad statements about the risks arising from accounting estimates for entities of different sizes – that is, even small entities can have accounting estimates that give rise to higher risks of material misstatement. This may occur, for example, if a small entity holds a complex financial instrument. Accordingly, the Task Force determined that the approach needed to be based on the nature and extent of risks arising from the accounting estimate, not the size of the entity that has the accounting estimate in its accounts.

Proposed Approach to Enhance Scalability of the ISA

13. The Task Force considered whether additional application material added throughout the ISA would be sufficient to explain how the requirements may be applied to lower risks of material misstatement arising from accounting estimates. The Task Force rejected this approach as it would be complex to explain and may not resolve underlying concerns about the volume and appropriateness of requirements when dealing with such lower risks.
14. As the Task Force discussions continued, it was noted that a key component of addressing accounting estimates was understanding what risks arose from the accounting estimates. The Task Force concluded that the auditor cannot assume that the risks arising from the accounting estimate are lower unless appropriate risk assessment procedures are performed. Accordingly, the Task Force also concluded that all accounting estimates should be subject to the same risk assessment procedures (see paragraphs 8–10A of **Agenda Item E-2**) so that appropriate responses can be designed and performed responsive to the risks of material misstatement that are present. This approach is consistent with extant ISA 315 (Revised),³ paragraph 12.

New Approach to Dealing with the Entity's Accounting Estimates as a Whole, Individual Accounting Estimates, and Risks Arising From Individual Accounting Estimates

The Task Force has decided that a clear language is needed to describe whether a requirement is aimed at the entity's accounting estimates as a whole, at individual estimates, or at risks of material misstatement arising from individual estimates. This hierarchy is evident in the drafting of the requirements, as is as follows:

- The accounting estimates as a whole are given the label “the accounting estimates” (plural).
- An individual accounting estimate is given the label “the accounting estimate” (singular).
- A risk of material misstatement arising from an individual estimate is called “the risk of material misstatement” and may be further distinguished by terms such as “lower risk” and “other than lower risk.”

15. The benefit of a strong risk assessment is that the work effort, informed by the full risk assessment, can be better tailored to address the actual risks of material misstatement arising from the accounting estimate – rather than the rigid, four option approach described in extant ISA 540. The Task Force proposes that the auditor be required to respond in accordance with ISA 330⁴ to the risks of material misstatement that are assessed as lower risk. For those risks of material misstatement that are assessed as lower risk, the auditor is not required to comply with paragraph 13 through 16A.

³ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁴ ISA 330, *The Auditor's Responses to Assessed Risks*

16. Under this approach, lower risks (including those that commonly arise from simpler accounting estimates) are explicitly carved out from the more granular aspects of the work effort, instead leaving these to be governed by the general rules set in other ISAs (such as ISA 330 and ISA 500).⁵ For those auditors who would appreciate more guidance, the work effort requirements in ISA 540 and the associated application material could be applied, adapted as necessary in the circumstances.
17. The advantages of this approach are that ISA 540 (Revised) can deal appropriately with all risks – whether lower risks or higher risks – without undermining the work effort on the higher risks. Lower risks involve corresponding lower degrees of estimation uncertainty, complexity, or judgment and, accordingly, share little in common with the risks that ISA 540 is primarily intended to address – that is, the risks that need a more specific and detailed approach. The Task Force believes that permitting such risks to be audited in accordance with the remainder of the ISAs will also allow a broader range of audit procedures to be applied. For example, substantive analytical procedures may be an appropriate response to risks arising from depreciation expenses, but substantive analytical procedures are not listed in paragraph 13 of extant ISA 540. The Task Force believes that this approach is consistent with the calls from stakeholders noted through the outreach activities.
18. The possible disadvantages of such an approach is that for these lower risks an auditor will be required to consult more than one standard. Having said that, almost all auditors use an audit methodology or audit software that integrates the respective ISAs into a comprehensive audit approach. Therefore, the Task Force does not believe this will result in undue cost or burden. It could also be argued that not addressing the work effort on such risks in ISA 540 may result in lower risks not being adequately audited. The Task Force does not accept this argument as: (a) by definition, these are lower risks and are correspondingly less likely to result in a material misstatement and ISA 540 is not specifically designed to address such lower risks; and (b) the auditor is still required to obtain sufficient appropriate audit evidence about such risks – the difference is in the specificity of the requirements to obtain the audit evidence.
19. In one area, the Task Force did see particular merit in additional application material. The Task Force considered the implications of the new internal control requirement in paragraph 8A of **Agenda Item E-2** (see also paragraphs 31–33 below) and was of the view that it would be useful to explain how these requirements affect the audits of small entities. The Task Force added application material (paragraph A38C and A38D) which highlights that the entity's internal control relevant to making accounting estimates within smaller entities is likely to differ from larger entities as smaller entities. The Task Force was of the view that internal control in smaller entities may use less structured means, simpler processes and procedures but also noted that management, or the owner-manager, is often closely involved in the operations. Through this involvement management, or the owner-manager, may be able to exercise more effective oversight of the estimation process.

Matter for IAASB CAG Consideration

1. Do the Representatives and Observers agree with the Task Force's intended approach of dealing with scalability, and more specifically with addressing lower risks arising from accounting estimates differently from other risks? (see paragraph 12A of **Agenda Item E-2**)

⁵ ISA 500, *Audit Evidence*

Section II: Definitions

20. The Task Force provided the IAASB with an updated definition section of ISA 540 for its June 2016 meeting. In the paper to the IAASB it was noted that extant ISA 540 contains six defined terms, some of which will need to be revised in light of changes elsewhere in ISA 540. The Task Force also proposed adding application material to the existing definitions as this could clarify the Board's intention with respect to the definitions.
21. The Task Force also proposed to the Board to define terms such as “method,” “model,” “data,” and “assumptions.” It was acknowledged that achieving consensus on these terms may be difficult, as definitions of each term abound and are often contradictory, but that the Task Force needed “working” definitions to ensure terms were being used consistently. These additional definitions could be included with ISA 540 (Revised) if they were seen to be helpful, but could also be removed if they were not needed.
22. Based on the discussion in the IAASB the Task Force was of the view that the proposed new definitions may be better placed in the application material as (a) overly precise definitions may cause more difficulties in practice; and (b) it is easier to explain the difference between the terms in application material, such as the difference between method and model and the difference between data and assumptions. The application material can also include examples that may clarify the IAASB's thinking. The Task Force therefore added application material to requirement 8 to explain what is meant by the terms:
- “Method” and “model”, including the difference between the two terms (Paragraph A23A);
 - “Data”, including a description of the difference between factual data and derived data, the different sources of data, and examples of data (Paragraph A26A–A26B); and
 - “Assumptions”, including examples of assumptions and a paragraph that explains that it may not always be clear whether a particular item is data or an assumption (Paragraph A26E–A26G).

Accounting Estimate

23. The Task Force has sought to simplify the definition of an accounting estimate and better align some of the terminology with that used in IFRS. When extant ISA 540, one of the major features of the standard was that it combined two older standards, one dealing with accounting estimates and the other addressing fair value measurements and disclosures. In light of this feature, much of the definition of an “accounting estimate” is concerned with making clear that the definition include fair value accounting estimates. As this is well understood in practice now, the Task Force believe that this material can be reduced and relocated to the application material.
24. The Task Force has also added application material (see paragraph A11B of **Agenda Item E-2**) that clarifies that the definition includes accounting estimates in disclosures and accounting estimates used to make a judgment about whether to recognize or disclose an amount.

Auditor's Point Estimate

25. The Task Force believes that the definition of an auditor's point estimate or auditor's range should be expanded to amounts or ranges developed to compare individual components of, or factors used in, the development of an accounting estimate. For example, an auditor may seek to make a point

estimate of one component of an accounting estimate – such as, the expected credit losses on a single portfolio of automobile loans rather than the entity's whole loan portfolio. The new paragraph A11C is intended to lay some of the groundwork for addressing this, but the Task Force will continue to consider whether this definition is needed as the finalization of the work effort section progresses. Preliminary outreach indicated support for the changes made.

Matter for IAASB CAG Consideration

2. The IAASB CAG is asked for its views on:
 - (a) The changes made to the existing definitions and the new application material related to these definitions; and
 - (b) The decision to explain the “method,” “model,” “data,” and “assumptions” through application material to paragraph 8.

Section III: Risk Assessment

The Entity and Its Environment

Method, Model, Data, and Assumptions

26. One of the key points noted in the Task Force's outreach is that the requirements and application material in ISA 540 may reflect relevant considerations for simple business environments, but could be modernized for more complex environments. Changes in the business environment, especially the increased use of information technology systems, complex models, and the use of data from external sources (including external data sources and data from outside the general and subsidiary ledgers), are currently not emphasized in ISA 540 and, therefore, the standard lacks the level of specificity that might be required to address the auditing challenges in a complex business environment.
27. In their respective March 2016 meetings, the IAASB CAG and IAASB were supportive of the Task Force's plan to strengthen the application material with respect to obtaining an understanding of data and models. This involves describing in more detail the matters that an auditor may obtain an understanding of when management uses a model, including the entity's internal control around model development.
28. To emphasize the importance of data, the Task Force added a new bullet (paragraph 8(c)(iA)) requiring the auditor to obtain an understanding of the data on which the accounting estimates are based. The application material (A26C and A26D) includes matters that the auditor may consider in obtaining this understanding, in particular highlighting the importance of adequate controls around data in high volume environments.
29. The Task Force also added application material in paragraph A25A, which is based on paragraph 49 of IAPN 1000.⁶ This paragraph explains matters that an entity may address when establishing or validating a model, whether management's own model or a third-party model. As the guidance in IAPN 1000 is written in the context of financial instruments, the Task Force has made modifications to the guidance to make it applicable to accounting estimates.

⁶ International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

The Nature of the Accounting Estimate and Related Disclosures

30. The Task Force noted that almost all requirements in the risk assessment are based on inquiry of management and therefore was of the view that the auditor's professional skepticism could be enhanced by requiring the auditor to make an independent assessment of the nature of the accounting estimates and disclosures that they would expect to see. The Task Force therefore included a requirement 8(aA), which is based on ISA 315 (Revised) paragraph 11, and related application material (paragraph A15A–A15B). The Task Force discussed ways how the auditor may obtain this understanding and concluded on the following matters:
- Understanding of the industry in which the entity operates;
 - Understanding of the applicable financial reporting framework;
 - Past knowledge and experience obtained through other audits and education; and
 - Previous experience with the entity.

The Entity's Internal Control Relevant to Making the Accounting Estimates

31. The outreach with stakeholders and the discussion in the IAASB CAG and the IAASB informed the Task Force of the importance of having more guidance on how to apply the requirements, in ISA 315 (Revised) related to the entity's internal control when understanding how management has made the accounting estimates. This was because of the increased use of large volumes of data that require extensive use of information technology in many circumstances. As a response to these calls the Task Force added new requirements to paragraph 8 and subsequently presented it to the IAASB for its June 2016 meeting.
32. The Task Force was of the view that it would be best to address the Board's concerns and the information obtained from outreach by drafting a new requirement (paragraph 8A) and related application material. This paragraph requires the auditor to obtain an understanding of the components of internal control relevant to accounting estimates:
- The control environment including the oversight and, if applicable, review and approval of the accounting estimates, by those charged with governance in making the accounting estimates;
 - The entity's risk assessment process;
 - The information system;
 - The control activities; and
 - The entity's activities to monitor controls.
33. The application material to this new requirement explains, among other matters, the following:
- The role of management and those charged with governance with respect to designing and implementing a system of internal control and how this is relevant to accounting estimates (paragraph A38G);
 - Matters that influence the effectiveness of the design of the control environment in relation to participation by those charged with governance (paragraph A38H);
 - Areas over which the auditor may consider obtaining an understanding of the extent of the review and approval of the accounting estimate by those charged with governance (paragraph

A38I);

- Circumstances when the review and approval of accounting estimates by those charged with governance may be particularly useful (paragraph A38J);
- Specific issues that can arise with respect to accounting estimates that require large volumes of data or require the extensive use of information technology (paragraph 38N);
- How information systems serve as an important source of information for the quantitative and qualitative disclosures in the financial statements (paragraph A38O);
- Matters that the auditor may consider in obtaining an understanding of the control activities relevant to making the accounting estimate (paragraph A38P) and, if management uses models, examples of relevant controls over models (paragraph A38Q);
- Areas where the work of the internal audit function may be particularly relevant (paragraph A38S).

Matters for IAASB CAG Consideration

3. The IAASB CAG is asked for its views on:

- The additional requirements and application material in paragraph 8 and 8A.
- The structure of paragraph 8A.

The Sensitivity of Accounting Estimates to Particular Data and Assumptions

34. In their respective March 2016 meetings, the IAASB CAG and IAASB generally supported the concept that the auditor should identify data and assumptions that have a “significant effect” on the accounting estimates. However, certain IAASB members questioned whether the term “key data and assumptions” should be used, as these terms are not currently used in the ISAs and could be confusing given that such terms create another area of focus in addition to the risk-based approach embedded in the ISAs. In addition, some IAASB members questioned using the term “significant” as it could be confusing given the concept of significant risk as included in ISA 315 (Revised).
35. Based on the IAASB’s input, the Task Force discussed how the concept of identifying data and assumptions to which the accounting estimates are particularly sensitive could be best incorporated in ISA 540. The Task Force considered the following two approaches, and in each case considered adding application material to explain the meaning of “particularly sensitive” and how the identification of data and assumptions to which the accounting estimates are sensitive may help the auditor:
- (i) Making changes to the wording to better articulate the requirement by changing the wording to “the auditor shall identify the data and assumptions to which the accounting estimate is particularly sensitive.”
 - (ii) Including the concept of the sensitivity of the accounting estimates to particular data and assumptions in requirements relating to the risk assessment (paragraph 8(c)(iv)) and the identification of and assessment of the risk of material misstatement (paragraph 10(a)).

The Task Force determined that the latter option is preferable, as it emphasizes the concept of sensitivity of the accounting estimates to particular data and assumptions throughout the audit of accounting estimates. The Task Force added application material that explains what is meant by

“particularly sensitive” (paragraph A38A) and how the identification of data and assumptions to which the accounting estimate is sensitive may help the auditor focus on the data and assumptions which drive the potential for risks of material misstatement and may also enable the auditor to better apply professional skepticism in the most relevant circumstances (paragraph A49A).

Retrospective Review (Paragraph 9)

36. Extant ISA 540 describes (in paragraph 9 of **Agenda Item E-2**) the retrospective review of prior period accounting estimates. Under the extant ISA 540, the auditor is required to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. Identify circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias.
37. Discussion in the Task Force indicated that there are a variety of views on when to perform the retrospective review and the Task Force therefore discussed ways to make this clearer in the requirements and the application material. Based on its deliberations, the Task Force was of the view that:
- For some accounting estimates, the retrospective review might not assist the auditor in identifying and assessing the risks of material misstatement in the current period. For example, for fair value accounting estimates, there is no observable outcome as the fair value determined at the reporting date will never be observed as it is a point estimate. In these circumstances the Task Force was of the view that a retrospective review should not be mandated. The Task Force also identified circumstances when previous accounting estimates may assist the auditor in identifying and assessing the risks of material misstatement:
 - When the accounting estimates have an outcome through transfer or realization of the asset or liability; or
 - When the accounting estimates are re-estimated for the purpose of the current period (such as may be the case with accounting estimates that exist beyond a single financial reporting period).
 - A retrospective review could be performed over several financial reporting periods or over a shorter period, such as half-yearly or quarterly, in addition to the retrospective review over the prior period as required by extant ISA 540. The Task Force therefore changed the wording ‘prior period accounting estimates’ to ‘previous accounting estimates’ in the requirement and included paragraph A42a in the application material.
 - In addition to the retrospective review at an accounting estimate level, it could be useful to perform a retrospective review over assumptions to which the accounting estimates are particularly sensitive. In that regard, the Task Force made changes to paragraph A42.
 - In paragraph A39, it was highlighted that, for accounting estimates with a high estimation uncertainty, the difference between prior year’s accounting estimate and the outcome may be significant because of the nature of the accounting estimate.

Auditor's Use of an Expert (Paragraph 9A)

38. A revision of ISA 620⁷ is outside the scope of the project to revise ISA 540, however the Task Force will consider recommending limited conforming amendments to ISA 620 as well as additional application material in ISA 540 where needed.
39. The Task Force has had preliminary discussions, based on the ISA Implementation Monitoring Report⁸ and outreach performed, about areas where application material could be included in ISA 540 in relation to using the work of the auditor's experts when auditing accounting estimates. The Task Force was of the view that application material can be developed that:
- Highlights why the decision to use an auditor's experts is important when auditing accounting estimates;
 - Explains the scope of work to be performed by the auditor on the expert's work in respect of accounting estimates; and
 - Includes examples of areas where the auditor might use an auditor's expert as the engagement team might have insufficient expertise with certain types of accounting estimates to perform necessary and appropriate procedures (e.g., to appropriately challenge the work of a management's expert and consider contradictory evidence).
40. For the risk assessment section, the Task Force discussed areas where using the work of an auditor's experts could be more emphasized and recognized that some accounting estimates require the use of specialized skills to properly identify or assess the risk of material misstatements. The Task Force was of the view that the decision whether or not to engage an auditor's expert in identifying or assessing the risk of material misstatement depends on the experience and knowledge of the engagement team and the nature of the accounting estimate. The Task Force included its thinking in paragraph 9A and added related application material in paragraph A44C – A44H.

Matters for IAASB CAG Consideration

4. The IAASB CAG is asked for its views on:
- How the Task Force has addressed the sensitivity of accounting estimates to particular data and assumptions;
 - The changes made to the retrospective review;
 - Areas where application material could be included in ISA 540 in relation to using the work of the auditor's experts when auditing accounting estimates; and
 - Whether the new requirement in paragraph 9A to assess whether an auditor's expert needs to be engaged for identifying and assessing the risk of material misstatement is useful.

Identifying and Assessing the Risks of Material Misstatement (Paragraph 10 and 10A)

41. The Task Force discussed whether the requirements and guidance in ISA 540 are sufficient to facilitate the identification and assessment of the risk of material misstatement at an appropriately

⁷ ISA 620, *Using the Work of an Auditor's Expert*

⁸ <https://www.ifac.org/system/files/publications/files/Implementation-Review-of-the-Clarified-ISAs.pdf>

granular level and whether more guidance could be helpful. The Task Force therefore considered whether some of the guidance in paragraph A45 could be elevated to a requirement to emphasize the factors that the auditor has to take into account in the evaluation of the degree of estimation uncertainty. This was presented to the IAASB CAG and IAASB in March 2016.

42. In its March 2016 meeting, the IAASB CAG questioned whether requirement 10, as presented, was still principles-based and noted that the amount of detail included would be expected in application material. The Task Force therefore considered ways to consolidate the factors into more overarching factors and concluded that the auditor should take into account the following factors in identifying and assessing the risks of material misstatement:
 - Estimation uncertainty;
 - Complexity in making the accounting estimate; and
 - The use of judgment.
43. In extant 540, estimation uncertainty plays an important role in identifying and assessing the risk of material misstatement as paragraph 10 states that 'the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate'. In their respective March 2016 meetings, the IAASB and IAASB CAG were of the view that estimation uncertainty is an important factor to consider in determining the risks of material misstatement when auditing accounting estimates.
44. The outreach conducted by the Task Force and discussion with the IAASB CAG and the IAASB has consistently pointed to auditing challenges posed by highly complex accounting estimates. In particular, the challenges that arise from the use of large volumes of data, complex models, assumptions or IT systems and the difficulty in obtaining relevant and reliable data. In their respective March 2016 meetings, the IAASB and IAASB CAG were of the view that complexity in making the accounting estimate is an important factor to consider in determining the risks of material misstatement when auditing accounting estimates.
45. The Task Force was furthermore of the view that the use of judgment is important to add as a factor as it plays an important role in making accounting estimates, since management has to select, for example, appropriate methods and assumptions or relevant and reliable data sources.
46. The Task Force discussed how the factors included in paragraph 10 differ from each other and was of the view that they may be interrelated but all come from a different angle risks of material misstatement related to estimation uncertainty may arise due to the environment or industry in which the entity operates, for example because of the volatility in jurisdictions or markets or the requirements of the applicable financial reporting framework. The risks of material misstatement arising from complexity in making the accounting estimate may come from the entity's business or structure, the requirements of the applicable financial reporting framework, or the entity's internal controls. The risk of material misstatement related to judgment may come from the decisions about the courses of action that, according to management, are appropriate in preparing the financial statements such as the selection of particular assumptions, models or data
47. In its discussion the Task Force noted that the factors may interrelate. For example, the financial reporting framework may be a source of estimation uncertainty (as it may require an assumption that may cause an inherent lack of precision), complexity (as it leads to the use of a complex method) and judgment (as it requires management to choose a method to make the accounting estimate).

48. In addition to the factors included in paragraph 10, paragraph A46 includes other relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement, including determining whether any of those risks are significant risks.
49. The Task Force also added application material to revised paragraph 10 that:
- Explains how the factors differ from each other (paragraph A44F);
 - Explains the interrelationships between the factors (paragraph A44G); and
 - Provides examples of the sources of risks of material misstatement that arises from estimation uncertainty, the use of judgment and the complexity in making the accounting estimates.

Identification of Significant Risk

50. In discussing paragraph 10 and 11 of extant ISA 540, the Task Force noted that many, if not all, of the factors that the auditor should consider in the identification and assessment of the risks of material misstatement related to an accounting estimate and the determination whether an accounting estimate would give rise to significant risk are similar.
51. In its June 2016 meeting the IAASB supported merging paragraphs 10 and 11 of ISA 540, as the IAASB was of the view that the factors used for the identification of the risks of material misstatement are the same as the factors used for the determination of which risks are significant.

Identification of Accounting Estimates with Lower Risk of Material Misstatement (Paragraph 10A)

52. In the response to the risk of assessment section in ISA 540, the Task Force added paragraph 12A which requires the auditor to respond, in accordance with ISA 330, to the risks of material misstatement that are assessed as lower risk. For these accounting estimates, the auditor is not required to comply with paragraphs 13 through 16A of **Agenda Item E-2**.
53. Extant ISA 540 requires the auditor to assess the risk of material misstatement but there is no requirement to assess the risk of material misstatement as lower (or higher) other than determining significant risks. The Task Force was therefore determined that a new paragraph (Paragraph 10A of **Agenda Item E-2**) that requires the auditor to make the assessment whether an accounting estimate has a lower risk of material misstatement. The Task Force included related application material that provides guidance on whether an accounting estimate may be assessed as having a lower risks of material misstatement. These preliminary factors identified are being further considered by the Task Force and may include:
- Routine, non-complex calculations that are subject to systematic processing and control;
 - Little or no estimation uncertainty; and
 - Minimal judgment by management over the selection of appropriate data and assumptions.

Matters for IAASB CAG Consideration

5. The IAASB CAG is asked for its views on:
- (a) The factors identified for identifying and assessing the risks of material misstatement, being estimation uncertainty, complexity, and judgment; and
 - (b) New paragraph 12A that requires the auditor to assess whether or not the risk of material misstatement is lower risk.

Section IV – Work Effort

Background

54. At the June 2016 IAASB meeting, the IAASB discussed the Task Force's initial thinking regarding the ISA 540 work effort.⁹ In brief, the discussion centered on the following matters:
- (a) Whether events occurring after the balance sheet date could resolve or address the lack of measurement precision that is the distinguishing characteristic of accounting estimates – meaning that no further procedures would be required to obtain sufficient appropriate audit evidence. This may occur in some limited circumstances, such as when the resolution of a legal matter provides strong evidence about a legal liability.
 - (b) The merits of a principles-based work effort requirement, complemented by more detailed requirements to address specific circumstances.
 - (c) Whether conditional requirements would be valuable in addressing specific risks – such as having a requirement to perform a specific procedure (or a set of procedures, or to choose procedures from a list) whenever a specific risk is present.
 - (d) The Task Force's initial drafting of a possible “stand back” requirement at the conclusion of the work effort. This requirement is intended to drive the auditor to take into account all the evidence obtained, whether corroborative or contradictory, and conclude whether the auditor has sufficient appropriate audit evidence regarding accounting estimates with high estimation uncertainty, high complexity or high levels of judgment.
55. The IAASB's comments on these proposals can be briefly summarized as follows:
- (a) Some support for the idea of a principles-based requirement as it allows for innovation over time to address evolving risks and circumstances, but also some concerns that it may not make any practical difference to the work performed.
 - (b) Some resistance to the level of detailed procedures. Some of this may have been a reaction to the initial drafting of these procedures needing some level of simplification. However, there was a core concern about overly detailed required procedures as some do not believe that the Board will be able to identify and describe the appropriate responses to all the potential risks that might be identified.

⁹ While not part of the IAASB CAG papers, interested representatives can refer to Section B-4 of (http://www.iaasb.org/system/files/meetings/files/20160621-IAASB-Agenda_Item_5A-ISA_540_Issues_Paper-Final.pdf) for the full explanation of the Task Force's initial thinking on the work effort.

- (c) One member asked the Task Force to identify when substantive procedures alone would not be sufficient – recognizing that this issue also affects other ISAs.
- (d) One member asked the Task Force to explore whether the full, detailed risk assessment is needed if the auditor already knows what approach will be used. For example, if the auditor has determined at the start that an auditor's own model will be used, what benefits are there in the auditor understanding how management made the accounting estimate, or whether management has used an expert?
- (e) With regard to significant risks, some members noted that it was the intensity of response that varied, rather than the type of audit procedures, while another member noted that for significant risks the degree of consistency across the evidence may need to be higher – in that the auditor has a lower tolerance for inconsistent (and contradictory) evidence.

Approach Included in Agenda Item E-2

- 56. The Task Force has continued to consider various alternatives to a revised work effort. The latest drafting developed by the Task Force is included in paragraphs 11A–16A of **Agenda Item E-2**. As noted in paragraph 7 above, the Task Force has discussed the work effort on several occasions but have not fully agreed on the draft wording to be used, nor has the application material been fully adjusted to fit with the revised requirements.
- 57. The approach to the work effort that the Task Force has focused on is described below:
 - (a) Paragraph 11A: Consideration of whether the auditor requires specialized skills or knowledge in order to obtain sufficient appropriate audit evidence. This procedure follows immediately after the auditor's assessment of risk, meaning that the auditor is considering whether specialized skills and knowledge are needed to perform any or all of the work effort requirements. This paragraph was in extant ISA 540 (as paragraph 14), but was relocated by the Task Force as it was seen to be sufficiently important that it needed to come earlier in the ISA. Paragraph A44F provides the bridge to ISA 620, and whether an auditor's expert is needed.
 - (b) Paragraph 12: This paragraph has not changed from extant ISA 540. It contains two specific procedures which are of particular importance to the audit of accounting estimates – both of which are based on the risk of material misstatement (that is, the higher the risk, the more persuasive the evidence required). The first procedure is to determine whether management's method appropriately applies the requirements of the applicable financial reporting framework relevant to the accounting estimate. The second procedure is to whether management's method for making the accounting estimate are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.
 - (c) Paragraph 12A: As discussed in Section I above, this procedure bifurcates the work effort. Lower risks are directed to ISA 330 instead of performing the procedures in paragraphs 13–16A.
 - (d) Paragraph 13: This is the key to the work effort in ISA 540 for risks other than lower risks. Based on the now expanded and enhanced risk assessment, the auditor now designs and performs procedures that are responsive to each risk. Unlike extant ISA 540, which provides four options of procedures to perform, the revised paragraph 13 is explicitly based on the

assessed risks of material misstatement as described in paragraph 10, being estimation uncertainty, complexity, and judgment as described in paragraph 10 (see Section III above).

- i. Importantly, the Task Force has focused on the need to ensure that all risks where there is other than lower risk are appropriately responded to. Of particular concern has been the perception that few significant risks¹⁰ are determined to exist and that auditors focus the majority of the work effort on those significant risks – with the practical effect that risks that are high (or, as some firms would say “elevated”) do not receive enough of the auditor’s attention. This has been a focus of the Task Force since early in the project, and the Task Force proposes that paragraph 13 should explicitly link the nature, timing and extent of procedures to be performed to the assessed risks of material misstatement, recognizing that the higher the risk, the more persuasive the audit evidence needed. The Task Force has liaised with the ISA 315 (Revised) Working Group in this regard.
- ii. The Task Force intends that the revised paragraph 13 will have more detailed and focused requirements that better support and require high quality audits. Paragraph 13 does this by limiting the auditor’s responses to the assessed risks to only the procedures in paragraph 13, unless another procedure is, in the auditor’s professional judgment, more responsive to the assessed risks (this is backed up by a documentation requirement in paragraph 23 to avoid the risk that this is misused).
- iii. The major innovation in paragraph 13 is the use of a table to list the procedures. The use of the table avoids the repetition that would otherwise be required if a more traditional approach was adopted. The table lists procedures in order of their relevance to the following broad areas: data and assumptions, management’s method for making the accounting estimate, and developing an auditor’s point estimate or range. In columns next to each procedures are ticks to indicate which of the factors in paragraph 10 the procedure is intended to address. Some procedures, of course, are broad and cover all three. Other procedures are most narrowly targeted and only cover one or two factors. The Task Force has sought to break some of the procedures in extant paragraph 13 into more detail so that the requirement is more explicit about what the procedure entails, thereby better linking the procedures to the risks it is intended to address.
- iv. The Task Force does not intend for the choice of procedures to be left only to the auditor’s professional judgment, although professional judgment is clearly critical to the work effort. The application material supporting paragraph 10 (paragraphs A44I–A49F of **Agenda Item E-2**) includes a non-exhaustive list of the risks of material misstatement that may arise from each of the factors. In this way, the factors in paragraph 10 are linked to the procedures responsive to the risks arising from those factors.
- v. For risks of material misstatement that do not arise from the factors in paragraph 10, the auditor needs to choose an appropriate procedure from the table that responds to the assessed risk, unless another procedure is more responsive to the assessed risk.
- vi. The Task Force has had only limited discussions about the way the procedures in the table are articulated, and whether all of the procedures are required for each factor. It is

¹⁰ ISA 315 (Revised) defines a significant risk as “An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration

acknowledged that work needs to be done about differentiating some of the procedures (or perhaps combining some), adding supporting application material, or making some of the procedures mandatory. In light of this, Representatives and Observers are asked to respond primarily to the structure and approach adopted with respect to the procedures, rather than overly focusing on the precise wording used.

- (e) Paragraph 13A: This paragraph contains conditionally mandatory procedures addressing the use of models, testing the operating effectiveness of controls, and evaluating management's intent to carry out specific courses of action.
 - (f) Paragraphs 14 and 15 of the extant ISA: These paragraphs address specialized skills and knowledge, and some specific procedures related to significant risks. They have been relocated to paragraph 11A and paragraph 13, respectively. With respect to paragraph 15, the Task Force noted that there was nothing specific to significant risks that made these procedures appropriate only for significant risks. In response to the Task Force's concern that higher risks (that are not significant risks) may not be given the appropriate auditor attention, the requirements of paragraph 15 have been moved to paragraph 13 to make them applicable to all risks arising from accounting estimates, other than lower risks (which are dealt with by ISA 330).
 - (g) Paragraph 16: This paragraph is focused only on significant risks and requires the auditor, if considered necessary, to develop a range with which to evaluate the reasonableness of the accounting estimate. The Task Force has not focused on this requirement yet, but has noted that the words "if considered necessary" may serve to undermine the intent of the requirement.
 - (h) Paragraph 16A: This is the proposed "stand back" requirement at the conclusion of the work effort discussed in paragraph 19(d) above.
58. The Task Force will continue to explore the changes needed to the work effort and will take into account the discussions at the September 2016 IAASB and IAASB CAG meetings. It is expected that the Task Force will discuss, amongst other matters which procedures should be mandatory, conditionally mandatory (that is, mandatory if a given condition is met – such as a risk of material misstatement related to a complex model) or optional.

Matters for IAASB CAG Consideration

6. What views do Representatives and Observers have on the work effort requirements (paragraphs 11A–16A of **Agenda Item E-2**)? Specific comment is sought regarding:
- (a) The lead-in to paragraph 13, including the focus on risks rather than the individual accounting estimate.
 - (b) The focus on higher risks, rather than focusing more on the defined term "significant risks."
 - (c) How much should the requirements be mandatory (including mandatory when a specific circumstance arises) versus requiring the auditor to determine the most effective procedures to respond to the risk?
 - (d) The clarity of the link between the factors in paragraph 10 and the procedures listed in the table in paragraph 13.
 - (d) The use of a table in paragraph 13 to list the procedures to be performed.

- (e) The “stand back” requirement in paragraph 16A.
- (f) Any other matter discussed in this section.

Significant Risks

59. In addition to the discussion in paragraphs 57(f) and (g) above, the Task Force notes that some IAASB members supported the idea that the intensity of response could vary for significant risks, rather than mandating certain specific procedures (regardless of why the risk was deemed to be a “significant risk”) as is done in extant ISA 540. It was also suggested that:
- (a) The auditor’s response to significant risks could require the involvement of more experienced employees – perhaps not specifically the engagement partner (who may not be best qualified to deal with all aspects of a complex accounting estimate) but an appropriately senior and experienced member of the engagement team.
 - (b) While contradictory evidence will always need to be taken into account, the auditor may have a greater need to look more closely at contradictory evidence for significant risks.
60. As noted above, the Task Force continues to develop this area, and does not have specific proposals to share in relation to these suggestions as yet.

Matter for IAASB CAG Consideration

7. Are there comments or perspectives that Representatives and Observers wish to share in relation to the work effort for significant risks?

Section V – Other Matters, Including Amendments to Other ISAs

Interactions with the Professional Skepticism Working Group

61. Recognizing the importance of the work of the Professional Skepticism Working Group to the revision of ISA 540, there continues to be active liaison between the two groups. At the June 2016 IAASB meeting, the Professional Skepticism Working Group presented recommendations¹¹ to the IAASB regarding ISA 540. In broad terms, these recommendations were:
- Restructuring of certain requirements to emphasize the importance of addressing inconsistent audit evidence.
 - To mandate discussions amongst the engagement team about the accounting estimates that represent risks due to a high level of estimation uncertainty inherent to the estimate, the absence or insufficiency of internal controls around the estimate, or the existence of potential indicators of management bias surrounding the estimate.
 - In the risk assessment section, consider more explicitly “what could go wrong.”
 - Describe in ISA 540 how documentation may assist auditors in making judgments requiring professional skepticism.

¹¹ http://www.iaasb.org/system/files/meetings/files/20160621-Agenda_Item_2-A-Professional_Skepticism_Issues-Paper.pdf

- Specific suggestions with respect to the work effort requirements and application material, including how to respond if management disagrees with the material misstatements identified by the auditor.

The Professional Skepticism Working Group also supported a number of initiatives already under consideration by the Task Force, including the stand back requirement in paragraph 16A and reinforcing material addressing management bias,

62. At the conclusion of the June 2016 IAASB meeting, the Task Force reported back to the IAASB on its initial discussion on these recommendations and noted the following:

- Some recommendations had been dealt with already by the Task Force, but that the detailed thinking of the Professional Skepticism Working Group would inform further deliberations.
- The Task Force noted a number of places in the ISA where alternative wording suggested by the Professional Skepticism Working Group could be used (i.e. “contradicts”/“inconsistent” or “challenge”/“question”). However, the Task Force had some concerns that this would not change auditor behavior, as it was not clear what the auditor would be required to do differently, nor how the auditor will be able to document the different actions.
- With regards to the discussion amongst engagement team members, the Task Force expressed some concerns that it may not be suited to smaller audits. The Task Force noted that it was worth considering whether the same objective can be accomplished by different means.

63. As the Task Force had a heavy workload over the period June-September, the Task Force has not explicitly returned to these points at the present time. However, the points have been noted by the Task Force and have informed some of the Task Force discussions.

64. It has been noted, particularly by one Task Force member, that the term “reasonable” is used in key places in the ISA, particularly with regard to the auditor’s assessment of assumptions and the development of an auditor’s range estimate. One Task Force member is concerned that the term “reasonable,” even with the application material in paragraph A78 of Agenda Item E-2, does not give the appropriate amount of direction to the auditor on what needs to be done in response. Other Task Force members have noted that sometimes the term “reasonable” is the best term, as the financial reporting framework may be specific about what is needed and a more qualitative approach is needed.

External Data Sources

Background

65. In its July 2016 Teleconference the IAASB discussed the Task Force’s preliminary thinking with respect to the use of external assistance by management and the auditor.

66. The use of external assistance by management is common in many entities. External assistance, which is addressed in International Standard on Auditing (ISA) 500, can be divided into the following categories:

- Management’s use of external data sources; and
- Management’s use of the work of an expert in preparing information.

67. Auditors may also make use of external assistance in performing the audit. The auditor's use of the work of an auditor's expert is addressed in ISA 620, whereas the auditor's use of external data sources is governed by the general audit evidence requirements in ISA 500.
68. The use of external data sources has been an area where the IAASB has considered new requirements and application material since the issuance of IAPN 1000 in 2011. When IAPN 1000, which includes some guidance on an entity's use of an external data source, was approved, it was acknowledged that amendments to the application material in ISA 500 and ISA 540 were needed relative to an entity's use of third-party data sources.
69. In the outreach performed by the Task Force's leadership, it was also noted that the guidance with respect to the use of external data could be enhanced. Stakeholders noted circumstances in which external data sources are either used by management or a management's expert as a source of data used in making an accounting estimate or are used by an auditor or by an auditor's expert to evaluate data or assumptions underlying a valuation that management has made. Outreach also indicated that further guidance as part of the ISA 540 project could be useful to explain the use of an auditor's expert when auditing accounting estimates and when management uses a model developed by an external source.
70. In August 2014 the United States Public Company Accounting Oversight Board issued a Staff Consultation Paper, Auditing Accounting Estimates and Fair Value Measurements.¹² One of the sections in this paper discusses the use of third parties, including the evaluation of audit evidence from third-party sources.

Scope

71. Based on the outreach performed by the Task Force's leadership and initial discussions within the Task Force, it was noted that the use of external sources for prices is still a concern for regulators, but that many entities also make use of external sources for data other than prices. Examples of data other than prices include: macro-economic data such as unemployment rates and economic growth rates, pricing related data, credit data, industry specific data, and mortality tables to determine liabilities in the life insurance and pension sectors. The IAASB agreed with the Task Force that data other than prices should be included in the scope of guidance developed by the Task Force.
72. Given the use of third parties for data other than prices, the IAASB was of the view that it would be more appropriate to refer to "data sources" instead of "pricing sources". The term data sources includes pricing sources. The IAASB was furthermore of the view that the use of "external" is more in line with the wording used in the ISAs and will therefore use the term "external data sources" instead of "third party pricing sources".

The Difference Between a Management's Expert and an External Data Source

Background

73. ISA 500 explains what constitutes audit evidence in an audit of financial statements, and deals with the auditor's responsibility to design and perform audit procedures to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion.

¹² https://pcaobus.org/Standards/Documents/SCP_Auditing_Accounting_Estimates_Fair_Value_Measurements.pdf

74. The distinction between a management's expert and an external data source influences the procedures to be performed by the auditor. This distinction is currently described, at a high level, in paragraph A35 of ISA 500.¹³
75. The IAASB discussed where in the ISAs the distinction between an external data source and a management's expert should be made and was of the view that making limited conforming amendments to ISA 500 would be the best approach given that some distinction between information from a management expert and data from an external data source is already included in paragraph A35 of ISA 500.
76. The IAASB was also of the view that the distinction between an external data source and a management's expert should be based on:
- Whether or not the data is specifically generated for the entity; and
 - Whether the data is widely available, regardless of whether or not a fee needs to be paid to access the data.
77. The IAASB also noted that there is no bright line between external data sources and a management's expert. For example, an individual or organization might be an external data source with respect to certain types of fair value measurements that are valued using observable inputs (e.g., when providing values for level 1 investments that are determined based on quoted prices) while the same individual or organization may function more like a management's expert (e.g., when providing values related to complex financial instruments that are not widely held and infrequently traded and therefore hard to value due to the absence of observable market data, or because only limited amounts of information are available). The Board also questioned whether there should be distinction in the auditor's work effort over data obtained from a management's expert and an external data source.

Work Effort over Data from External Data Sources

78. As part of the development of IAPN 1000, some initial drafting suggestions to ISA 500 were made with respect to the nature and extent of the audit procedures to be performed over third-party pricing sources. It was noted that the nature and extent of procedures to test management's use of third-party pricing sources depends on the observability of inputs and complexity of methods for a specific security or asset class. It was also noted that the nature and extent of the procedures performed by the auditor depends in part on the availability of information from the source – that is, alternative procedures may need to be performed if sufficient information is not available from the external data source to enable particular procedures to be performed. The Task Force generally agreed with the approach taken in the development of IAPN 1000 and was of the view that a similar risk based approach with respect to external data would be useful.

¹³ Paragraph A35 of ISA 500 "When information to be used as audit evidence has been prepared using the work of a management's expert, the requirement in paragraph 8 of this ISA applies. For example, an individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate which the entity uses in preparing its financial statements, the individual or organization is a management's expert and paragraph 8 applies. If, on the other hand, that individual or organization merely provides price data regarding private transactions not otherwise available to the entity which the entity uses in its own estimation methods, such information, if used as audit evidence, is subject to paragraph 7 of this ISA, but is not the use of a management's expert by the entity."

79. Based on preliminary discussion in the IAASB and within the Task Force, the following guidance is intended to be developed:
- Addressing reliability of data obtained from an external source including consideration of the existence of bias in data obtained from external data sources.
 - Addressing challenges in obtaining sufficient appropriate audit evidence from external data sources, including when:
 - The external data source will not disclose information about the data, such as how the data is accumulated, calculations in the production of the data, and the process used to generate the data (including any controls over the process that may be relevant in determining the reliability of the information provided), because of confidentiality or proprietary reasons
 - The information needed to determine whether fair values are based on transactions of comparable assets or liabilities is generally only available at an aggregated level, and at a security level via a 'deep dive,' for which external data sources may limit the number that their customers, including companies and auditors, may request.
 - Addressing situations when management and the auditor use the same external data source.

Management's Use of External Models

80. In its outreach, the Task Force was informed that external models are either:
- Developed by an external model source and obtained and used by management to make the accounting estimate; or
 - Obtained and used by an external data source to produce data which is used by management to make the accounting estimate.

These models may be developed for the entity specifically or may be publicly available.

81. The IAASB agreed with the Task Force's view that models are not external data as models apply assumptions and data, and a set of relationships between them, as specified by the method used to make the accounting estimate. When an external model is used to make an accounting estimate additional risks of material misstatements may exist (e.g., management may not understand or have access to the internal workings of the model to determine if it complies with accounting standards or is otherwise appropriate for the entity's use). Given the different characteristics between external data sources and external models, the IAASB was of the view that external models should not be included in the scope of guidance on external data sources but that requirements or guidance would be useful to help the auditor design and perform appropriate audit procedures to address risks related to external models.
82. The Task Force will continue to work on the topic of external data sources and will develop revised proposals for inclusion in the forthcoming ED.

Matters for IAASB CAG Consideration

8. The IAASB CAG is asked for its views on:
- (a) The factors to distinguish between an external data source and a management's expert as described in paragraph 49.
 - (b) The areas in which the Task Force will develop guidance in ISA 540 with respect to the work effort over external data sources (as described in paragraph 53).

Reporting Implications

Background

Selected Paragraphs from ISA 701 (Emphasis Added)

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).⁵ (Ref: Para. A19–A22)
 - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)...
- A23. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures.²⁷ In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.
- A24. However, users of the financial statements have highlighted their interest in accounting estimates that have been identified as having high estimation uncertainty in accordance with ISA 540²⁸ that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management's expert and an auditor's expert.
83. A significant change in the ISAs since the current version of ISA 540 was drafted is the revised auditor's report, including the communication of key audit matters. Accounting estimates often require significant auditor attention and the new possibility of communicating key audit matters may assist auditors in communicating directly with users.
84. As the IAASB was well aware that accounting estimates often require significant auditor attention, ISA 701¹⁴ includes references to accounting estimates in key places. The box above this section highlights some of the key references to accounting estimates in ISA 701.

¹⁴ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

85. The IAASB also made conforming amendments to ISA 540 as a result of the auditor reporting project. Additional application material was added to paragraph A114 to draw attention to the communication of key audit matters in the auditor's report:

A114. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. Where applicable, the auditor may also determine that an accounting estimate that has been identified as having a high estimation uncertainty is a key audit matter to be communicated in the auditor's report in accordance with ISA 701, or may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report (see ISA 706 (Revised)).¹⁵ If the matter is determined to be a key audit matter, ISA 706 (Revised) prohibits the auditor from including an Emphasis of Matter paragraph in the auditor's report.¹⁶

Task Force Recommendation

86. The Task Force believes that ISA 701, and the amendments to ISA 540, collectively set appropriate requirements and provide adequate guidance with respect to the new key audit matters section of the auditor's report. Accordingly, staff propose only a minor amendment to ISA 701 to bring it into line with the new focus on the complexity of accounting estimates and the judgment involved thereon in ISA 540:

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).⁵ (Ref: Para. A19–A22)
 - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty, high complexity, or involve high levels of judgment. (Ref: Para. A23–A24)
 - (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

87. In relation to ISA 540, an additional reference to ISA 701 is proposed to paragraph A123 of **Agenda Item E-2**. The Task Force will consider whether further guidance is needed, but do not expect to make major changes.

Matter for IAASB CAG Consideration

¹⁵ ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

¹⁶ ISA 706 (Revised), paragraph 8(b)

9. Representatives and Observers are asked to share their views on whether they support the changes to ISA 540 or ISA 701 described above.

Communication with Those Charged With Governance and Management

Communication with Those Charged With Governance

88. ISA 260 (Revised)¹⁷ contains specific material regarding communications with those charged with governance. Currently, paragraph 16(a) of ISA 260 (Revised) contains the following accounting-estimate specific material:

The auditor shall communicate to those charged with governance...[t]he auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

89. IAPN 1000 also refers to communication with those charged with governance. It notes that because of the uncertainties associated with the valuation of financial instruments, the potential effects on the financial statements of any significant risks are likely to be of governance interest. Of the matters listed in IAPN 1000,¹⁸ the following may be most suitable for inclusion in ISA 540 as matters for communication to those charged with governance:
- (a) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
 - (b) The relative materiality of the accounting estimates to the financial statements as a whole;
 - (c) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates, particularly financial instruments;
 - (d) Significant deficiencies in the internal control or risk management systems relating to accounting estimates;
 - (e) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to valuations performed by management or a management's expert;
 - (f) Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
 - (g) The auditor's views about the appropriateness of the selection of accounting policies and presentation of financial instrument transactions in the financial statements;
 - (h) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for financial instruments;
 - (i) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with financial instruments;

¹⁷ ISA 260 (Revised), *Communication with Those Charged with Governance*

¹⁸ IAPN 1000, paragraph 143–144

90. The above matters have been included in ISA 540 as paragraphs 22A and A127A and have been adapted as necessary to reflect the broader scope of ISA 540 compared to IAPN 1000.

Communication with Regulators

91. During the outreach activities conducted by the ISA 540 Task Force, it was noted that effective two-way communication between the auditor and a financial institution's regulator (with or without the presence of management) is key to the respective roles of the auditor and the regulator.
92. ISA 540 currently has no references to communications with a regulator. IAPN 1000 has application material as follows:

In some cases, auditors may be required,¹⁹ or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments. Such communication may be useful throughout the audit. For example, in some jurisdictions, banking regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.

93. In light of the importance of financial institution audits, the Task Force proposes that an amended version of this material be included as application material in ISA 540 (see paragraph A127B). It is acknowledged that this will not be sufficiently detailed for financial institutions with mandatory communications with regulators, however this is best dealt with via an appropriate IAPN, rather than in ISA 540 that applies to all audits.

Matter for IAASB CAG Consideration

10. What views do Representatives and Observers have on new paragraphs 22A and A127A–A127B?

Documentation

94. In the course of the ISA 540 outreach activities, it was noted that documentation of the auditor's work regarding accounting estimates was important for a number of reasons:
- Adequate documentation helps the auditor demonstrate the judgments made and the rationale for those judgments. This is particularly necessary when the accounting estimate requires management to make subjective judgments; and
 - Inspection findings²⁰ have noted that accounting estimates have given rise to a number of identified audit deficiencies. Clear documentation requirements will assist auditors in demonstrating the procedures performed (or the lack of procedures performed) and will better support inspectors in conducting audit inspections and focusing on the sufficiency of and appropriateness of audit evidence obtained in the audit.

¹⁹ For example, ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires that, if the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether law, regulation or relevant ethical requirements require the auditor to report to an appropriate authority outside the entity, or to establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

²⁰ ISA 230, *Audit Documentation*

95. The Task Force proposes amendments to paragraphs 23 and A128 of **Agenda Item E-2**. These amendments, together with ISA 230, are intended to require additional documentation of :
- (a) The rationale for the auditor's judgment to use, or not to use, an auditor's expert when dealing with accounting estimates with high estimation uncertainty, high judgment, or high complexity;
 - (b) How the auditor addressed the indicators of management bias;
 - (c) The basis for how the auditor demonstrated professional skepticism in auditing the accounting estimates, including relevant matters related to the auditor's overall conclusions about the reasonableness and appropriateness of the accounting estimates, and their disclosure, and the significant professional judgments made by the auditor regarding accounting estimates with high estimation uncertainty, high complexity, or high judgment.
 - (d) When the auditor has performed other procedures that are more responsive to the risk of material misstatement (see paragraph 13), a description of the other procedures and the auditor's rationale for why they are more responsive to the identified risk. (Ref: Para. A128)

Matter for IAASB CAG Consideration

11. What comments does the Task Force have on the amendments proposed to paragraph 23 and A128?

Insurance Contracts

96. One area that the Task Force has noted warrants investigation is the upcoming Insurance Contracts standard. The Task Force received a briefing from representative of the IASB regarding the upcoming Insurance Contracts standard. In the presentation, the following areas were noted as being areas of key judgments:
- Probability weighted estimates of expected cash flows
 - Based on expectations of behavior;
 - Claim events (hurricanes, death);
 - Investment returns for participating contracts (especially if guaranteed)
 - Discount rates that
 - Reflect the characteristics of the cash flows of the insurance contract
 - Are consistent with observable current market prices
 - Risk adjustment
 - Level of aggregation based on similar risks and profitability
 - Applying the Standard for the first time
97. The Task Force notes that the key judgment areas were consistent with the Task Force's current thinking regarding other complex estimates (such as expected credit losses and complex financial instruments), and that some guidance may be warranted to draw attention to those matters. The Task Force added a relevant insurance example to paragraph A3 of Agenda Item E-2. This approach is consistent with the treatment of expected credit losses.

Matter for IAASB CAG Consideration

12. Do Representatives and Observers have views on areas of the ISA where material related to insurance contracts should be added?