

**ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures – Issues****Minutes – January IAASB Teleconference**

Mr. Sharko introduced the topic and explained the outreach conducted with regulators, practitioners and others since the September 2015 IAASB meeting. He noted that the Working Group drafted a project proposal to revise ISA 540 and developed a publication to update stakeholders on the project's progress (the Project Publication). He highlighted that the Project Publication identified the audit issues relating to Expected Credit Losses (ECL), and the preliminary views of the Working Group on what related action the Board may consider in the revision of ISA 540.

**PROJECT PROPOSAL**

Mr. Sharko introduced the project proposal to revise ISA 540 by highlighting the objectives of the project proposal, the issues to be addressed, and how the project to revise ISA 540 serves the public interest. He also highlighted the key comments that the IAASB CAG Representatives and Observers raised in their December 2015 teleconference.

Board members expressed broad support for the project proposal as presented in Agenda Item 4-B. In addition to some editorial comments, the following matters were noted with regard to the clarifying or further enhancing the project proposal and the actions to be taken in commencing the project:

- Emphasize the importance of exercising professional skepticism throughout the audit of accounting estimates and the Task Force should consider whether the definition of management bias needs to be enhanced.
- Consider whether guidance is necessary to help auditors better understand the sources and characteristics of high estimation uncertainty.
- Clarify that accounting estimates, in addition to impacting the balance sheet, have corresponding impacts on statements of performance, and that greater use of complex accounting estimates can stem from fair value measurements but also other measurement bases. It was also noted that often only certain aspects of accounting estimates are challenging.
- Clarify that it is not the intent of the project to increase the disclosures beyond those required by financial reporting frameworks.
- Conduct outreach with organizations that represent SMPs beyond the International Federation of Accountants' SMP Committee.
- Clarify that future publications to update stakeholders on the project's progress may be issued periodically to inform stakeholders about the evolving discussions at the Task Force and IAASB levels.

#### PIOB OBSERVER REMARKS

Mr. Holm noted that the proposed timetable is challenging. Given the effective date of IFRS 9,<sup>1</sup> he highlighted the importance of meeting the proposed deadlines. He also highlighted the importance of taking into account the audit implications of accounting estimates for insurance contracts.

#### IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron noted that CAG Representatives and Observers supported the project proposal to revise ISA 540 and agreed with the key comments raised by the CAG Representatives and Observers as presented by the Task Force. He also noted the CAG Representatives' and Observers' interest to be frequently engaged on this topic.

#### APPROVAL

Subject to addressing the matters noted above, the IAASB unanimously approved the project proposal to revise ISA 540 with 17 affirmative votes out of the 17 Board members present.

#### PROJECT PUBLICATION

Mr. Sharko introduced the Project Publication by noting that its purpose is to provide an outline of the project proposal and to highlight the significant audit challenges that may arise as a result of ECL. He explained that the project publication will explain the audit issues identified by the Working Group regarding ECL, highlight the Working Group's thinking on those issues in light of existing ISAs and International Auditing Practice Notes, and identify areas that the Working Group may explore as part of the project to revise ISA 540. Mr. Sharko also highlighted the drivers and the challenges of issuing the Project Publication and the feedback received from stakeholders.

Generally, the Board supported the Project Publication as included in Agenda Item 4-C. Board members provided, in addition to editorial suggestions, the following comments:

- The IAASB asked the Task Force to consider whether the document could be restructured and retitled to make the two objectives of the document clearer. It was suggested that the material on how the identified issues may be addressed in the ISA 540 project could be expanded to make it more useful to readers.
- Some Board members questioned if another form of non-authoritative guidance, such as a Staff Alert, might be more appropriate, as some practitioners might find comments about the future direction of the project to revise ISA 540 unhelpful. Others disagreed, noting that requests for audit guidance had come from both practitioners and regulators and therefore it is important for the IAASB to provide these stakeholders with guidance to help facilitate auditors' early responses to the challenges posed by ECL models. It was also noted that CAG Representatives and Observers generally supported the section that describes the possible future direction of the project and that including this section in the Project Publication signals that the needed responses from auditors to ECL models will likely have an impact on ISA 540.
- It was noted that a clear list of issues or "action items" may help readers track the IAASB's progress on the issues.

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<sup>1</sup> International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

- Support was noted for the outreach that the Working Group has conducted to date. The Task Force was encouraged to engage in further outreach throughout the project to ensure that relevant issues are being appropriately considered.

The Board also highlighted several areas that could be enhanced or that could be included in Section IV of Agenda Item 4-C, as follows.

- Several suggestions were made on how to clarify and expand the possible future direction sections to provide more detail on the possible changes to ISA 540.
- It was noted that the Task Force could include material linking to the auditors' responsibility to communicate with those charged with governance as described in ISA 260 (Revised)<sup>2</sup> and ISA 265.<sup>3</sup>
- With respect to challenges with data and assumptions, it was noted that the controls around systems and high volume accounting estimates could be emphasized in the considerations that may aid the auditor in considering management's use of data, including forward-looking data. The importance of consistent use of data within an entity and the role that regulators play therein was also highlighted.
- Support was noted for the proposed more granular risk assessment and the proposed stronger link between significant risks and certain characteristics of accounting estimates. It was questioned whether rebuttable presumptions would be the best future direction.
- With respect to understanding and assessing models and controls thereon, the importance of being involved in the implementation process was highlighted given the ability to suggest adjustments early on in the implementation process. Mr. Holm agreed and highlighted that small changes in a model can have a material impact on the financial statements and therefore stressed the importance of change management controls over models.
- It was suggested to elaborate on management's and the auditor's use of experts in dealing with ECL models and to emphasize that key audit matters in accordance with ISA 701<sup>4</sup> can also be applied voluntarily for entities other than listed entities.
- It was suggested to combine the possible future direction sections into one section in order to reduce repetition and improve the readability. The combined possible future direction section would also enable the Task Force to summarize matters that are more holistic. Others preferred the approach taken by the Task Force as this approach could make future updates easier.

Mr. Waldron highlighted the importance of obtaining CAG Representatives' and Observers' input on the project on a timely basis and more frequently than may be the case for other projects.

#### WAY FORWARD

The IAASB will consider an updated version of the Project Publication at its January 2016 teleconference. The ISA 540 Task Force will bring issues around the revision of ISA 540 to the March 2016 IAASB meeting.

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<sup>2</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>3</sup> ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

<sup>4</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

### **Objective of the IAASB Discussion**

The objective of the IAASB discussion at its March 2016 meeting is to receive input on the ISA 540 Task Force's (the Task Force) analysis of issues identified and the Task Force's proposed responses based on the discussions by the Task Force to date.

## **Section A: Introduction**

1. In December 2015 the International Auditing and Assurance Standards Board (IAASB) approved the project proposal to revise International Standard on Auditing (ISA) 540. This paper provides an update on the 540 Task Force's activities, the issues identified and initial Task Force views on how these issues can be addressed through modifications to ISA 540.

### *Outreach Conducted to Date*

2. As the Task Force's original objective was to address audit issues related to financial institutions, the Task Force performed most of its outreach in 2015 with stakeholders in the financial institutions industry. Even though the Task Force and the IAASB noted that most issues that were identified as part of the outreach are likely to be applicable to non-financial institutions as well, additional outreach to non-financial institutions was performed.
3. The Task Force's outreach included discussions with the International Organization of Securities Commissions, the International Forum of Independent Audit Regulators, the International Accounting Standards Board and the Chartered Financial Analyst Institute. The Task Force also reviewed the ISA Implementation Monitoring Findings<sup>5</sup> report. The issues raised by respondents to the ISA Implementation Monitoring project can be summarized under four themes: (i) applying ISA 540 to complex accounting estimates, such as loan loss provisioning, the valuation of certain financial instruments, or goodwill impairments, (ii) risk assessment procedures, (iii) work effort on management assumptions; and (iv) the relationship between accounting estimates and significant risks. See the appendix for an abstract of the findings related to ISA 540 as included in the ISA Implementation Monitoring Findings report.
4. The Task Force plans to continue its outreach activities, although less outreach is expected to be needed in 2016.

### *Task Force Activities Since December 2015 IAASB Meetings*

5. During its physical meeting, the Task Force discussed ISA 540 issues that arise from non-financial institutions and identified many areas where accounting estimates play a critical role, including but not limited to:
  - Calculation of reserves in extractive industries;
  - Asset retirement obligations;
  - Revenue recognition;
  - Business combinations;

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<sup>5</sup> [www.ifac.org/publications-resources/clarified-isas-findings-post-implementation-review](http://www.ifac.org/publications-resources/clarified-isas-findings-post-implementation-review)

- Goodwill/ Intangible assets impairment;
  - Valuation of level 3 financial instruments;
  - Pension liabilities;
  - Contingent liabilities;
  - Share based compensation;
  - Deferred taxes; and
  - Leases.
6. The results of these discussions have informed the Task Force of the preliminary issues and challenges in auditing accounting estimates which are discussed in the subsequent sections of this Agenda item. The areas discussed included:
- Scope of ISA 540 (see Section B-1)
  - Professional Skepticism (see Section B-2)
  - Risk Assessment Procedures and Related Activities (see Section B-3)
  - Identification and Assessment of Risk of Material Misstatement (see Section B-4)
  - Response to identified Risks of Material Misstatement (see Section B-5)
  - Other Considerations (see Section B-6).
7. The sections below include, in some places, initial drafting that the Task Force has prepared to enable the IAASB to better understand the Task Force's thinking, considerations, and options for the way forward. The drafting is presented for discussion purposes only, and is not indicative of a formal recommendation by the Task Force. Importantly, the Task Force has not attempted to draft application material to support the drafted requirements at this early stage in the project.

#### **Matters for IAASB Consideration**

1. Does the IAASB see the need for further outreach to specific stakeholders to cover non-financial institution issues?
2. Does the IAASB agree that the audit challenges outlined in paragraph 6 are the most significant areas that need to be addressed by the Task Force? Are there additional areas that should be considered by the Task Force?

## **Section B-1: Scope of ISA 540**

### **B-1.1 Complexity versus Estimation Uncertainty**

8. As a result of the Task Force's discussions and outreach, it is clear that there are two different, but interrelated, paradigms that exist when discussing where the significant auditing challenges lie in dealing with accounting estimates: the degree of estimation uncertainty and the complexity of the accounting estimate. It is clear that, in some cases, the risk of material misstatement may be significantly influenced by the estimation uncertainty of the accounting estimate; there are other cases where the complexity of the estimation process contributes to the risk of material misstatement,

however estimation uncertainty may or may not be high. What is not clear is whether, and to what extent, the two are related, merit a similar or dissimilar audit response, and whether ISA 540 should be enhanced to reflect this.

### *Estimation Uncertainty*

9. Some believe the focus of ISA 540 should be on identifying and responding to estimation uncertainty. Estimation uncertainty is defined in paragraph 7(c) of ISA 540 as “the susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.” This approach is consistent with much of ISA 540 and is implicit in the structure of ISA 540. For example:
  - Paragraph 2 of ISA 540 explains that the nature and reliability of information available to management varies widely, which affects the degree of estimation uncertainty, which affects the risks of material misstatement.
  - Paragraphs 10 and 11 of ISA 540 require the auditor to evaluate the degree of estimation uncertainty associated with an accounting estimate, and determine whether any of those estimates with high estimation uncertainty give rise to significant risks. Further, paragraphs 15 and 16 of ISA 540 contain specific requirements regarding estimation uncertainty for accounting estimates that give rise to significant risks.
10. Relevant application material in ISA 540 with respect to estimation uncertainty includes the following matters:
  - Factors that influence the degree of estimation uncertainty (paragraph A45)
  - Examples of accounting estimates that may have high estimation uncertainty (paragraph A47)
  - Circumstances when estimation uncertainty is so high that a reasonable accounting estimate cannot be made (paragraph A49)
11. The Task Force notes that the definition of estimation uncertainty, and the associated application material needs to be considered in the course of this project. In particular, the Task Force notes that:
  - The definition of estimation uncertainty is based on the concept of a lack of precision in the measurement of an accounting estimate. The Task Force notes that it may be difficult for an auditor to practically measure or assess the level of precision in measuring an accounting estimate.
  - Many stakeholders mention accounting estimates with “high” estimation uncertainty as indicative of a risk of material misstatement, but there is no definition of, or criteria for, what “high” estimation uncertainty is. As ISA 540 does not currently have a definition or criteria for high estimation uncertainty – and defining high, moderate, or low estimation uncertainty may prove challenging.

### *Complex Accounting Estimates*

12. The outreach conducted by the Task Force has consistently pointed to auditing challenges posed by highly complex estimates. In particular, the challenges that arise from the complexity of the requirements of the financial reporting framework, and the complexity of the systems, processes and judgments that are involved in management making the accounting estimate. It is noteworthy that the

IAASB issued IAPN 1000<sup>6</sup> as a response to complex financial instruments and the Task Force will consider whether some of the guidance in IAPN 1000 can be included in any revisions made to ISA 540.

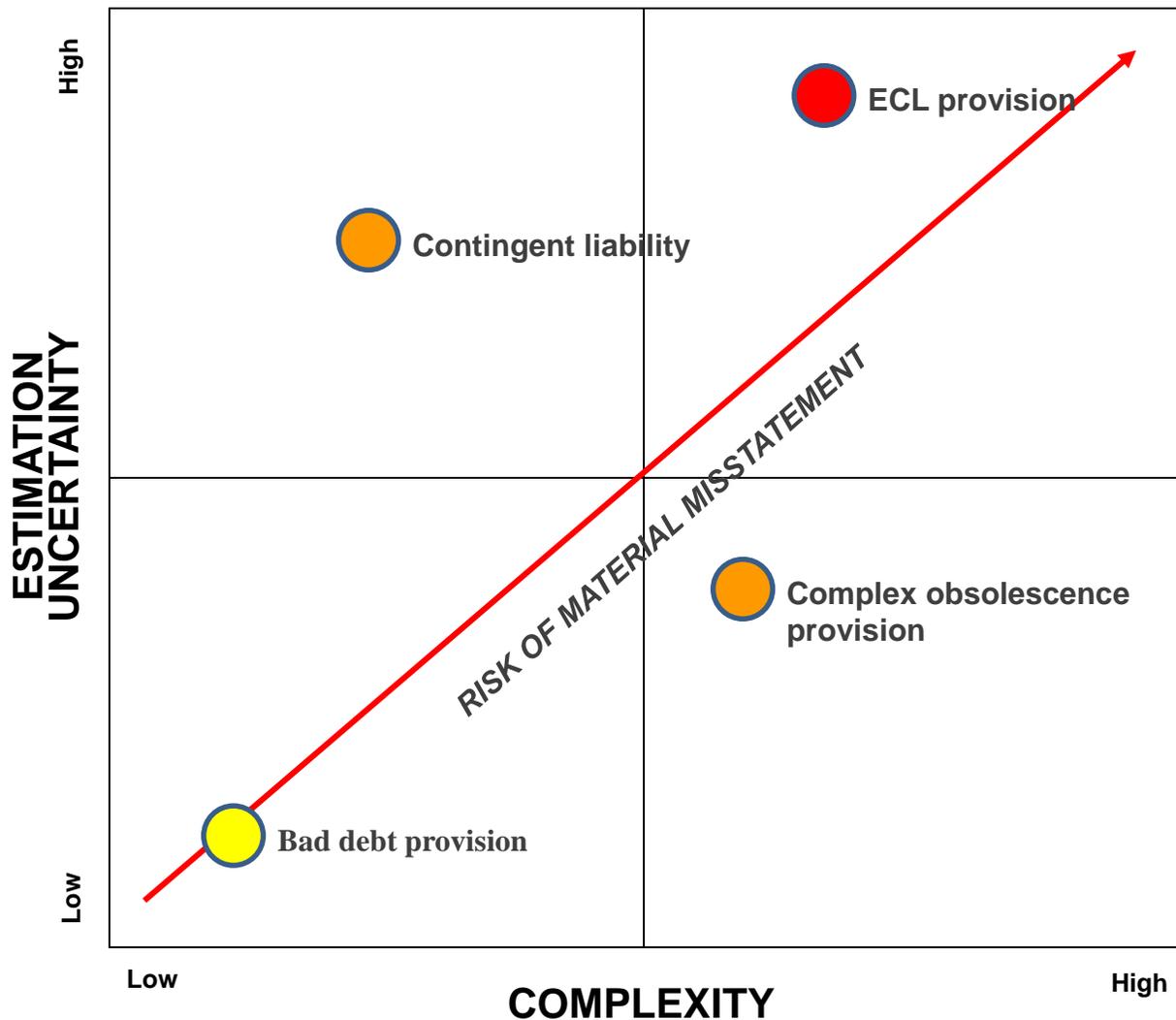
*Effect of Complexity and Estimation Uncertainty on Risk Assessment*

13. The Task Force notes that the interaction between complexity and estimation uncertainty has implications for the auditor's risk assessment and, consequently, work effort, which is illustrated in Figure 1 below. The risk of material misstatement is highest in the top right corner as there is a combination of high estimation uncertainty and the data and or model used to calculate the accounting estimate requires complex systems and processes. Conversely the lower left corner represents accounting estimates where there is a lower risk of material misstatement because these factors are not present. Figure 1 also includes possible account balances and transactions that could be in each area of the figure – recognizing that differing circumstances make such broad generalizations difficult.
14. There are scenarios where the accounting estimate has low estimation uncertainty but requires complex systems, processes and judgments, for example an obsolescence provision for inventory with a wide array of different inventory types and inputs. Equally there are other scenarios where the accounting estimate has high estimation uncertainty, but the uncertainty may be derived from a single critical judgment, for example a single, clearly identifiable, level 3 financial instrument or a legal contingency.
15. The interactions between addressing complexity and estimation uncertainty or a combination of both has obvious implications for the discussion on how ISA 540's scope could be clarified. The Task Force's discussions noted that it would be difficult to have two different paradigms (complexity and estimation uncertainty) in the ISA, and it would be best to seek the IAASB's input on this point. It is possible that the definition of estimation uncertainty (see paragraph 9) could be amended to include reference to complexity, but this risks confusing two discrete concepts.

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

Figure 1: Estimation Uncertainty and Complexity



### B-1.2 Should the Scope of ISA 540 be Clarified?

16. An accounting estimate is defined in the ISAs as ‘an approximation of a monetary amount in the absence of a precise means of measurement’. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where the ISAs address only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.<sup>7</sup>
17. ISA 540 is applicable for all accounting estimates, ranging from the simplest accounting estimates (such as depreciation of tangible fixed assets), to those that arise in environments where complex models or inputs are used (such as financial instruments at level 3 of the fair value hierarchy, expected credit losses, or insurance contract liabilities). Findings from the ISA Implementation Monitoring project highlighted that many amounts appearing in financial statements are accounting

<sup>7</sup> ISA 540, paragraph 7

estimates and applying all of the requirements of ISA 540 to these accounting estimates may be seen to be impractical and does not contribute to audit quality. In addition, the Task Force questioned whether having the same requirements for all accounting estimates, except accounting estimates that give rise to a significant risk, might be overly cumbersome for certain accounting estimates.

18. The Task Force therefore considered whether changing the scope of ISA 540 or emphasizing the scalability of ISA 540 could alleviate the concerns raised in Paragraph 17. To this end, the Task Force discussed the following options:
- a) **Split ISA 540 into two standards**; one standard for accounting estimates with a low estimation uncertainty and the other standard for all other accounting estimates. This option has the merit of allowing each standard to better cater for the issues likely to be encountered in different situations, rather than the current “one size fits all” approach, and provide an opportunity to strengthen the work effort on accounting estimates that do not give rise to a significant risks but do nevertheless have a moderate or high estimation uncertainty. However, the Task Force notes that splitting ISA 540 into two standards may be seen as creating more complexity as practitioners would have to determine which standard would apply to an accounting estimate.
  - b) **Scope accounting estimates with low estimation uncertainty out of ISA 540** and therefore the requirements and guidance in ISA 540 would only be applicable for accounting estimates with moderate or high estimation uncertainty. This would mean that accounting estimates with low estimation uncertainty would be treated the same as non-accounting estimates and therefore the auditor would use ISA 315 (Revised),<sup>8</sup> ISA 330<sup>9</sup> and ISA 500<sup>10</sup> to determine which procedures to perform based on the assessed risk of material misstatement. The auditor may however find the requirements and guidance in ISA 540 of use when auditing those accounting estimates scoped out of ISA 540.
  - c) **Emphasize and clarify the scalability of ISA 540**: this would mean retaining the existing scope of ISA 540 but emphasizing and clarifying how ISA 540 can be applied to engagements of different sizes. This may include, for example, including a new paragraph in the ‘Scope of this ISA’ section that highlights the scalability of ISA 540 based on the estimation uncertainty or the complexity involved in making the accounting estimate. Scalability could also be emphasized in the requirement that describes the response to the assessed risk of material misstatement within the standard (paragraph 13 in ISA 540) and in the related application material. The ISAs are written to be principles based and scalable; therefore emphasizing and clarifying the scalability of ISA 540 should be achievable within the requirements and application material without amending the scope of ISA 540.
19. In its preliminary discussion of which approach could be taken most Task Force members were leaning towards option C but it was noted that more extensive discussions were deemed necessary to make a final recommendation to the Board. The Task Force also noted that emphasizing the scalability of the ISAs or changing the scope of ISA 540 would especially benefit auditors of as Small- and Medium Entities as these entities, generally, have fewer complex accounting estimates than

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<sup>8</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>9</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>10</sup> ISA 500, *Audit Evidence*

larger entities. Making the ISAs more scalable would be responsive to demands from the Small and Medium Practices (SMP) Committee that changes in auditing standards should not increase the work effort for SMPs as noted in the project proposal.

20. The Task Force will also consider whether an accounting estimate that management made at year end should be within the scope of ISA 540 when events or information occurring up to the date of the auditor's report become available that resolve the estimation uncertainty.

#### **Matters for IAASB Consideration**

3. The IAASB is asked to provide views on the discussion above regarding the question of addressing complexity and/or estimation uncertainty as a focus for the ISA. In particular, the Task Force invites views on whether the IAASB would see merit in investigating whether ISA 540 should also focus on the complexity of the accounting estimate.
4. The IAASB is asked to provide views on the scope of ISA 540 in light of the discussion of the matters outlined above, including which of the options in paragraph 18 should be further investigated, if a change to the scope is sought. The IAASB is also asked whether there are options favored by members that are not included in options (a) through (c) in paragraph 18.

### **Section B-2: Professional Skepticism**

21. Professional skepticism is defined in the ISAs<sup>11</sup> as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.” Discussions within the Task Force, and outreach conducted to date, have highlighted that exercising professional skepticism throughout the audit is particularly important for accounting estimates that are complex or have been identified as having high estimation uncertainty, including when the range of possible outcomes for the accounting estimate is multiples of performance materiality.
22. In addition, inspection findings highlighted that the guidance in ISA 540 could be clearer to aid all parties, including firms and regulators, in understanding the standards' intent as it relates to challenging the reasonableness of assumptions adopted by management in making the accounting estimate, including the consideration of contrary or inconsistent evidence, when it exists.
23. The Task Force therefore considered ways to strengthen the exercise of professional skepticism within ISA 540. The Task Force was of the view that professional skepticism could be strengthened through enhancements to existing wording in ISA 540 (see paragraph B.2-1) and in the following areas:
- Risk assessment procedures (see paragraph B-3.5)
  - Responses to large ranges in an auditor's range estimate (see paragraphs B-5.2)
  - Assessing contrary or inconsistent evidence (see paragraphs B-5.3)
  - Evaluation phase (To be discussed by the Task Force)
24. The sections below represent the Task Force's initial thinking on the issues. The Task Force will be

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<sup>11</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 13

liaising with the Professional Skepticism Working Group to further elucidate these thoughts, and to seek additional input.

### **B-2.1 Emphasize Professional Skepticism through Wording Used in ISA 540**

25. The Task Force considered whether professional skepticism could be strengthened by changing the wording of ISA 540 and identified some areas where further consideration could be given to the language used. For example, currently the objective of the standard states that ‘the objective of the auditor is to obtain sufficient appropriate audit evidence about whether: (a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable’<sup>12</sup> The word ‘reasonable’ was perceived by many to be vague and very broad as a lot of things are reasonable and not clearly defined.<sup>13</sup> It was noted that the IASB’s conceptual framework<sup>14</sup> also doesn’t have a definition of ‘reasonable’ but that some key terms used are ‘faithfulness’ and ‘relevance’, which will be considered by the Task Force to determine if they can more clearly define ‘reasonable.’
26. Several of the procedures that are listed in paragraph 13 of ISA 540 use the word ‘evaluate’. The Task Force considered whether another word could be used to promote professional skepticism. For example, one of the areas where this could be done is by changing in paragraph 13(b) of ISA 540, the word ‘evaluate’ to ‘challenge’, i.e., in the sentence ‘In doing so, the auditor shall evaluate whether: ...’. Some were of the view that changing this word could foster a more skeptical mindset. However, other Task Force members were of the view that “evaluate” had a broader meaning than “challenge” and that the Task Force should investigate alternatives ways of achieving the objective of increasing professional skepticism.
27. The Task Force also noted that responding to the assessed risks of material misstatement for an accounting estimate by following the procedures that management has performed<sup>15</sup> may bias the practitioner’s thinking as initial impressions may subconsciously be directed to only evaluate what management has considered to be appropriate even though other options could be assessed. (the risk of “anchor” thinking).

### **B-2.2 Bias**

28. An area where a skeptical mindset is particularly important is the assessment of whether there are indicators of management bias. The Task Force notes that paragraph 21 of ISA 540 could be enhanced by including a reference to ISA 240 to more explicitly draw the auditor’s attention to the possibility that management bias represents a risk of material misstatement due to fraud.<sup>16</sup> It was also noted that the requirement could be strengthened by taking into account possible management bias with respect to disclosures and the aggregate effect of management bias. The Task Force was of the view that all estimates are likely to have some form of bias occurring as a result of the method

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<sup>12</sup> ISA 540, paragraph 6

<sup>13</sup> Paragraph A77-A83 in ISA 540 include matters that the auditor can consider in evaluating the reasonableness of assumptions used by management underlying fair value accounting estimates,

<sup>14</sup> [http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED\\_CF\\_MAY%202015.pdf](http://www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf)

<sup>15</sup> ISA 540, requirement 13(b)

<sup>16</sup> ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

chosen or as a result of a bias in the selection or weighing data estimates. Including specific reference to these inherent biases that may exist in methods (including models) and data sources would be responsive to some of the points noted on the outreach about inherent biases in a model being a key focus of the audit when dealing with the most complex estimates. Inherent biases in a model can occur as a result of the method chosen or as a result of a bias in the selection or weighing of data.

29. The Task Force discussed the initial drafting of the requirement as included in the text box below and will further discuss the enhancements to the application material that would address the findings from the outreach.

21. The auditor shall:

- (a) Review the judgments and decisions made by management in the making of, and disclosures relating to, accounting estimates, both individually and in aggregate, to identify whether there are indicators of possible management bias. This shall include considering inherent biases that may exist in methods and data sources;
- (b) In accordance with paragraph 32 of ISA 240, evaluate whether the circumstances producing the bias, if any, represent a risk of material misstatement due to fraud.

Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.  
(Ref: Para. A124–A125)

30. The Task Force notes that application material would be needed to further explain these points.
31. The Task Force also discussed the concept of “auditor bias”, as the auditor can also lack neutrality in the audit of an accounting estimate because of, for example, their familiarity to the client or a certain model or method. The Task Force is looking into different options for how to address auditor bias, including adding a specific requirement or application material in ISA 540 to address auditor bias. Given that the concept of auditor bias is not solely related to ISA 540, the Task Force is of the view that this issue might be best addressed holistically in conjunction with the Professional Skepticism working group.

#### **Matter for IAASB Consideration**

5. Recognizing that the Task Force’s deliberations are at an early phase, the Board is asked to comment on the discussion above and the draft amendments to paragraph 21.

### **Section B-3: Risk Assessment Procedures and Related Activities**

32. ISA 540 describes in paragraph 8 the risk assessment procedures to be performed by the auditor. Findings from the ISA Implementation Monitoring project indicated that there is inconsistency in the work effort around obtaining an understanding of accounting estimates, including the underlying data, the model used, internal consistency of management assumptions used and how management has assessed estimation uncertainty. This was also echoed in the Task Force’s outreach and the Task Force, therefore, focused on several parts of the risk assessment procedures including:
- Governance and Controls over Models and Data (B-3.1)
  - Model Development and Validation (B-3.2)

- Key Data and Assumptions Underlying Accounting Estimates (B-3.3)
  - Retrospective review (B-3.4)
  - Applying Professional Skepticism (B-3.5).
33. A major feature of the Task Force's deliberations has been for the auditor to perform the risk assessment at a more granular level. As noted by some IAASB members at the December 2015 IAASB meeting, the risk of material misstatements may be most strongly influenced by one or more elements of the accounting estimate, and focusing the auditor's attention on these elements is critical to a high quality audit.
34. In addition, the Task Force discussed the use of work of experts and information from third party data sources, and included a summary of the discussions and a proposed way forward in section B-6.1. In future meetings the Task Force will also have specific deliberations about the drivers of the risk of material misstatement with respect to accounting estimates, and the appropriate response thereto.

### **B-3.1 Governance and Controls over Models and Data**

35. The level of sophistication of an entity's internal control environment can differ significantly depending on the complexity of the entity's processes. Outreach and Task Force discussions indicated that the requirements and application material in ISA 540 work well for simple control environments but could be modernized for more complex environments. Changes in the business environment, especially the increased use of information technology systems and the use of data from external sources (including third-party data sources and data from outside the traditional accounting systems), 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 of a complex business environment.
36. The Task Force's initial thinking is that more specificity in paragraph 8 of ISA 540 and further enhancements in the application material would foster a more consistent work effort in addressing circumstances where accounting estimates are generated using large volumes of complex system-generated data that are based on internal sources. The Task Force discussed the initial drafting of the requirement as included in the text box below and will further discuss the enhancements to the application material that would address the findings from the outreach.

#### **Risk Assessment Procedures and Related Activities**

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA 315 (Revised),<sup>17</sup> the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)
- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13–A15)
  - (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of

<sup>17</sup> ISA 315 (Revised), paragraphs 5–6 and 11–12

management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16–A21)

- (c) How management makes the accounting estimates including, ~~and an understanding of the data on which they are based, including:~~ (Ref: Para. A22–A23)
- (i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24–A26)
  - (ii) The data on which the accounting estimate is based, including whether data has been obtained from external sources and the governance; (Ref: TBA)
  - ~~(ii)~~(iii) Relevant controls over the accounting estimate; (Ref: Para. A27–A28A)
  - ~~(iii)~~(iv) Whether management has used an expert; (Ref: Para. A29–A30)
  - ~~(iv)~~(v) The assumptions underlying the accounting estimates; (Ref: Para. A31–A36)
  - ~~(v)~~(vi) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37)
  - ~~(vi)~~(vii) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38)

### B-3.2 Model Development and Validation

37. The Task Force discussed different challenges auditors may face in obtaining an understanding of the model used to develop the accounting estimate. The Task Force discussed the auditor's approach to understanding the entity's model development and validation and responding to the assessed risks of material misstatement in models.
38. Paragraph 8(c)(i) of ISA 540 requires the auditor to obtain an understanding of the model, if any, used in making an accounting estimate. The application material could be strengthened by describing in more detail the matters that an auditor may address when establishing or validating a model, whether it be management's own model or a third-party model, including the governance structure around model development. The Task Force is of the view that application material similar to paragraph 49 of IAPN 1000 would be useful.<sup>18</sup>
39. The Task Force also notes that communication with management and those charged with governance (TCWG) early in the process may assist in addressing some of the audit challenges that arise during the development process of the models.<sup>19</sup>

<sup>18</sup> Paragraph 49 of IAPN 1000 explains matters that an entity may address when establishing or validating a model, whether management's own model or a third-party model. While this guidance is written in the context of fair value accounting estimates, many of the matters are also relevant to other accounting estimates.

<sup>19</sup> In some industries, like the banking and insurance industry, the regulatory supervisor is required to approve certain models before they are used by management.

### B-3.3 Key Data and Assumptions Underlying Accounting Estimates

40. The Task Force noted that the performance of risk assessment procedures and related activities early in the audit will aid auditors in focusing on data and assumptions used in models that have a significant effect on the model's output, and which drive the potential for risks of material misstatement.
41. The performance of risk assessment procedures and related activities also enables professional skepticism to be applied where it is likely to be most effective. However, the focus on data and assumptions should not detract the auditor from looking at the accounting estimate from a more holistic perspective, as a holistic overview could provide useful information about possible management bias (e.g., all assumptions used for an accounting estimates could be reasonable but they can all be slightly biased in one direction and therefore in combination not reasonable).
42. A majority of the Task Force was of the view that a new requirement or guidance, including a definition of key data and assumptions, could be included in ISA 540 to further emphasize the matters noted above. The Task Force discussed the initial drafting of requirement as included in the text box below, recognizing that such a requirement would need to be supported by adequate application material.

8A. Based on the auditor's understanding obtained in accordance with paragraph 8 of this ISA, the auditor shall determine whether there are key data and assumptions that have a significant effect on the accounting estimate. (Ref: TBA)

### B-3.4 Retrospective Review

43. The Task Force explored to what extent the retrospective review, as required by paragraph 9 of ISA 540, can be revised in order to provide more useful information for auditors to assess possible management bias. Under the extant standard 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. The objective of this review is to:
  - Obtain information regarding the effectiveness of management's prior period estimation process, from which the auditor can judge the likely effectiveness of management's current process;
  - Obtain audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates;
  - Obtain audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements; and
  - Identify circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias.
44. Discussion in the Task Force indicated that there are a variety of views on the objective of, and how to perform, the retrospective review. The Task Force was, therefore, of the view that more application material could be useful to highlight that, in certain cases:
  - A retrospective review could be performed over several 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 ISA 540. It was noted that in certain circumstances individually small changes to

assumptions that are not significant year over year become significant when aggregated over several years.

- It may be useful to perform a retrospective review over key assumptions in addition to the retrospective review at an accounting estimate level.

### **B-3.5 Applying Professional Skepticism in the Risk Assessment**

45. The Task Force was of the view that exercising professional skepticism as part of risk assessment is critical given its impact on the rest of the audit. When performing risk assessment procedures, the auditor should particularly have a questioning mind when obtaining an understanding of the judgments and decisions made by management in making accounting estimates in order to identify where there is a heightened risk of possible management bias. In that respect it was noted that focusing on those areas and assumptions of the accounting estimate that have the most significant impact on the model's output, and which drive the identification of the potential for risks of material misstatement is important given the heightened risk of management bias in these areas.
46. Paragraph 8 of ISA 540 includes specific requirements that the auditor should perform in relation to accounting estimates to obtain an understanding of the entity and its environment. Currently the standard is written in such a way that it requires the auditor to understand management's process to identify transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements and how management makes the accounting estimate. The Task Force noted that this approach could create "anchor" thinking, as the auditor uses management's view as the starting point for identifying accounting estimates. Having said that, the Task Force also notes that management is responsible for making the accounting estimates, and the auditor needs to base their assessment, to some degree, on what management's considerations were. This is applicable in all cases, but is particularly relevant when the financial reporting framework requires management to assess their own intentions. For example, criteria for classification and measurement of financial instruments under IFRS 9<sup>20</sup> is firstly driven by the characteristics of the financial instruments and secondly by the fundamental aspects of the activity. However, management's intention should be considered based on the facts and circumstances. The practitioner could corroborate management's assumptions regarding the classification with decisions made in the past in similar situations (business activities).
47. The Task Force is also of the view that professional skepticism in ISA 540 can be strengthened by including application material that would have the auditor focus on the internal consistency of management's assumptions and obtaining an understanding of the controls, if any, management has in place that may have a mitigating effect on management bias. Especially in larger entities, different assumptions might be used between different departments and obtaining an understanding of why these differences exist would be useful to the auditor's evaluation. The Task Force will also consider whether documentation requirements regarding the auditor's consideration of professional skepticism in the risk assessment may help to drive increased skepticism.

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<sup>20</sup> International Financial Reporting Standard (IFRS) 9, section 4.1

**Matter for IAASB Consideration**

6. The IAASB is asked to provide views on the discussion on the risk assessment and related activities in light of the discussion above and the draft amendments to paragraph 8 and 8A.

**Section B-4: Identification and Assessment of the Risk of Material Misstatement**

48. In identifying and assessing the risks of material misstatement, as required by ISA 315 (Revised), the auditor is required to evaluate the degree of estimation uncertainty associated with an accounting estimate.<sup>21</sup> Based on this, the auditor is then required to determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.<sup>22</sup>
49. The Task Force discussed whether the demarcation of the work effort between significant risks and non-significant risks as it currently exists under ISA 540 is sufficient for the audit of accounting estimates as it recognized that only a limited number of accounting estimates will be identified as having risks of material misstatement that are significant risks. It was also noted through outreach activities by the Task Force, discussion within the Task Force and by some regulators that many auditors may not identify more than a few significant risks regardless of the complexity of the entity they are auditing.
50. Some of the Task Force members are of the view that the increase in risk, and the related responses to assessed risks, should be more continuous and the Task Force discussed how, under the current risk assessment and identification model, this could be incorporated. See also section B-5.

**B-4.1 Evaluation of the Degree of Estimation Uncertainty**

51. The Task Force discussed whether the requirements and guidance in ISA 540 are sufficient to facilitate identification and assessment of estimation uncertainty at an appropriately 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. The Task Force discussed the initial drafting of paragraph 10 of ISA 540 as included in the text box below, recognizing that it would also require the drafting of additional application material.

10. In identifying and assessing the risks of material misstatement, as required by ISA 315 (Revised),<sup>23</sup> the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. In doing so, the auditor shall take into account the following factors: (Ref: Para. A45–A46)
  - (a) The extent to which the accounting estimate, including management's decisions regarding the selection of methods, data, and assumptions, depends on judgment and is susceptible to management bias.

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<sup>21</sup> ISA 540, paragraph 10

<sup>22</sup> ISA 540, paragraph 11

<sup>23</sup> ISA 315 (Revised), paragraph 25

- (b) The sensitivity of the accounting estimate to changes in data sources or assumptions.
- (c) The existence and use of recognized measurement techniques.
- (d) The length of the forecast period, and the relevance and reliability of data drawn from past events to forecast future events.
- (e) The availability of relevant and reliable data from internal and external sources.
- (f) The extent to which the accounting estimate is based on observable or unobservable inputs.
- (g) Whether alternative methods, data, or assumptions could have a material effect on the accounting estimate by varying the method, data, or assumptions used in management's model. (Ref: TBA)

52. Application material will be needed to further explain the factors noted above and the interrelationships (if any).

#### **B-4.2 Link Between Accounting Estimates with High Estimation Uncertainty and the Existence of a Significant Risk of Material Misstatement**

53. The ISA Implementation Monitoring Findings report and the Task Force's outreach highlighted that some respondents were of the view that a stronger link needs to be made between accounting estimates with a high degree of estimation uncertainty and the existence of a significant risk. The Task Force therefore discussed options for how this could be incorporated in ISA 540:

- Include a rebuttable presumption in ISA 540 that all accounting estimates with a high estimation uncertainty give rise to one or more significant risks. Adding a rebuttable presumption would strengthen the relationship between accounting estimates with a high degree of estimation uncertainty and the existence of a significant risk but it was also noted that, in practice, rebuttable presumptions are often rebutted.
- Identify more accounting estimates with a high estimation uncertainty as containing one or more significant risks by adding further application material regarding when risks of material misstatement related to accounting estimates are likely to be significant risks. See also section B-4.3 which discusses if factors beyond estimation uncertainty should be included to identify significant risks.

The Task Force will further discuss these options. The Task Force notes that the need for, and importance of, these options depends largely on decisions made about the scope and scalability of ISA 540.

#### **B-4.3 Factors Beyond Estimation Uncertainty to Identify Significant Risks**

54. Paragraph 11 of ISA 540 states that the auditor 'shall determine whether, in the auditor's judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.' Outreach conducted by the Task Force indicated that some stakeholders were of the view that ISA 540 can be strengthened by highlighting in the application material that the auditor should take into account the general principles of identifying accounting estimates as

described in ISA 315 (Revised)<sup>24</sup> when identifying significant risks. Application material could highlight specific matters related to accounting estimates, like complex processes, that might give rise to significant risks.

#### **B-4.4 Communication with Those Charged with Governance and Regulators**

55. ISA 540 does not include specific guidance about the communication of accounting estimates that have a high estimation uncertainty and that may give rise to a significant risk with TCWG or regulators. Based on the outreach performed the Task Force is of the view that application material similar to paragraph 145 of IAPN 1000, could be useful. This paragraph states that in some industries, like the banking and insurance industry, communication with regulators might be beneficial or is mandatory based on local laws and regulations. This guidance could be used as a hook for a future IAPN on the relationship between the financial institution's regulatory supervisor and the external auditor. In addition conforming amendments could be made to ISA 260 (Revised)<sup>25</sup> to include ISA 540 in Appendix 2 of ISA 260 (Revised).<sup>26</sup> The Task Force will also consider whether the requirements in AS16<sup>27</sup> to communicate with TCWG regarding "critical accounting estimates" may be useful.

##### **Matter for IAASB Consideration**

7. The IAASB is asked to provide views on the discussion on the identification and assessment of the risks of material misstatement for accounting estimates in light of the discussion above and the draft amendments to paragraph 10.

### **Section B-5: Response to identified Risks of Material Misstatement**

#### **B-5.1 Work Effort on Accounting Estimates**

56. ISA 540 requires the auditor to perform additional procedures to respond to the identified risk of material misstatement for accounting estimates that give rise to a significant risk. Paragraph 13 of ISA 540 requires the auditor to apply one or more procedures from a list of four procedures. Additional requirements are included in paragraph 15 through 17 of ISA 540 for accounting estimates that give rise to a significant risk.
57. As noted in Section B-4, accordingly to the Task Force's outreach, some auditors identify only a limited number of significant risks regardless of the complexity of the entity they are auditing. Especially in larger entities there could be several accounting estimates that do not have risks of material misstatement determined to be significant risks, but nevertheless may require a more robust response to address the identified risks of material misstatement than other accounting estimates. As the ISA 315 Working Group just started its deliberations the Task Force did not want to prejudge the conclusions of that working group. Therefore, the Task Force discussed the following options that link the work effort closer to the identified risks of material misstatement:

<sup>24</sup> ISA 315 (Revised), paragraph 26(a), A128 and Appendix 2

<sup>25</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>26</sup> Appendix 2 of ISA 260 (Revised) includes specific matters that could be communicated to TCWG for accounting estimates that are significant.

<sup>27</sup> [pcaobus.org/Standards/Auditing/pages/auditing\\_standard\\_16.aspx](http://pcaobus.org/Standards/Auditing/pages/auditing_standard_16.aspx)

- Emphasize more prominently in paragraph 13 that the procedures to be performed by the auditor are scalable depending on risk of material misstatement associated with the accounting estimate. It was noted in the outreach performed that inconsistencies exist between the level of estimation uncertainty and the nature of procedures performed to appropriately address the estimation uncertainty. This emphasis could be done by highlighting in the requirements that the auditor needs to obtain more persuasive audit evidence for those risks of material misstatement that are “higher”, and performing a combination of the procedures listed in paragraph 13, or alternative procedures, until sufficient appropriate audit evidence has been obtained to address the risk.
  - Link the work effort required by the auditor on accounting estimates to estimation uncertainty and the complexity involved in making the accounting estimate instead of significant risks. Taking into account the proposed changes in the scope of ISA 540, it is possible to carve out accounting estimates with a low estimation uncertainty from ISA 540 (see section B-1.2). For accounting estimates with moderate or high estimation uncertainty, the auditor needs to apply the procedures as required by the revised requirement 12 and 13 and additional procedures for accounting estimates that have a high estimation uncertainty.
58. Under both options the Task Force was of the view paragraphs 12 and 13 of ISA 540 should be more granular and be more like a menu of options that the auditor must consider performing in response to the assessed risk of material misstatement. The Task Force discussed several options including:
- Explaining the difference between paragraph 8 and 13(b) and 15. The Task Force was of the view that the difference between the two requirements might be too subtle as paragraph 8 requires the auditor to “obtain an understanding” of several factors with respect to accounting estimates, while paragraph 13(b) requires the auditor “to evaluate” how management made the accounting estimate and the data it is based on. The Task Force was of the view that ISA 540 could be enhanced by explaining what the purpose is of the word “evaluate” in auditing accounting estimates.
  - The Task Force was of the view that the auditor should evaluate, for accounting estimates within the scope of ISA 540 that the method of measurement is appropriate in the circumstances and evaluate that the assumptions used by management are reasonable in light of the measurement objectives. The combination of obtaining an understanding and evaluating the accounting estimate should provide the auditor with a clear steer to determine which procedures to perform to test the accounting estimate. The proposed changes would lead to requirements in paragraph 8, 12 and 13 requiring the practitioner to, respectively, obtain an understanding of the accounting estimate, evaluate the accounting estimate, and test the accounting estimate.
59. The Task Force also discussed whether the procedures as included in paragraph 13 are still sufficient for today’s audit environment. For example, outreach indicated that, in some cases, auditors put their own assumptions through management’s model to assess what the impact would be of different assumptions on the accounting estimate. The Task Force was therefore of the view that it would be useful to add, in addition to paragraph 13(a)-(d) in ISA 540, the following options for procedures in paragraph 13:
- Develop an independent point estimate or range for a key data or assumption to challenge management’s choice of the key data or assumption.

- If management use a third-party in making the accounting estimate, testing the operating effectiveness of controls, including controls at the entity or at the third party that may have the effect of mitigating management bias, together with appropriate substantive procedures.

### **B-5.2 Auditor Developed Ranges and Point Estimates**

60. ISA 540 has an optional procedure for the auditor to develop a range or point estimate to evaluate management's point estimate (see paragraphs 13(d) and A87-A91 of ISA 540). From the Task Force's outreach, it is clear that, in some circumstances, auditors do not choose to develop a point estimate or range because:
- a) The modelling of the estimate to develop a point estimate or range would not be a possible method of evaluating management's point estimate due to the complexity of the model and the need for extensive systems to support the development of the model; and
  - b) The result of the auditor's modelling process may not be helpful in evaluating management's model due to the wide variations of outcomes that can result from small changes to inputs.
61. The discussions in the Task Force focused in first instance on the conceptual idea of ranges. It was noted that ISA 540 requires that the range encompass all reasonable outcomes – and, to some, this implies that any point estimate within this range is acceptable from an audit perspective. It is noted that paragraph 21 of ISA 540 requires the auditor to review the judgments and decisions made by management in making the accounting estimates to identify whether there are indicators of management bias – and one indication of management bias may be if accounting estimates are consistently at one end of the auditor's range of reasonable outcomes.
62. The Task Force also discussed how the auditor should assess a difference between management's point estimate and the auditor's range. The guidance in paragraph A94 of ISA 540 addresses this matter but it could be strengthened to more clearly identify what the auditor should do in situations when management's point estimate falls within the range that the auditor's considers to be reasonable. This would be particularly critical in areas where the accounting estimates has a reasonable range that is higher than performance materiality due to a high level of estimation uncertainty.

#### *Management Addressing Estimation Uncertainty*

63. Paragraph 15(a) requires the auditor, for accounting estimates that give rise to a significant risk, to evaluate how management has considered alternative assumptions or outcomes, and why management has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. If, in the auditor's judgement, management has not adequately addressed the effects of estimation uncertainty, paragraph 16 requires the auditor, if considered necessary, to develop a range with which to evaluate the reasonableness of the accounting estimate.
64. The Task Force notes that the requirement to develop a range, if considered necessary, may be difficult for the reasons noted in paragraph 60 above. Accordingly, the Task Force believes that further work is needed to identify what factors the auditor should consider in deciding whether management has adequately addressed estimation uncertainty and how the use of a skeptical mindset can be promoted in this area. The Task Force also notes that, subject to further discussion by the Task Force, the obligation to develop a range could also be broadened to include alternative procedures that may

achieve the same objective. The Task Force notes that estimation uncertainty may be largely addressed in management's disclosures and, therefore, a greater focus by the auditor on the related disclosures may be necessary.

#### Disclosures

65. Task Force discussions highlighted that disclosures are of particular importance when dealing with accounting estimates with high estimation uncertainty, as disclosures regarding such accounting estimates are critical to users' understanding of the estimation uncertainty. See section B-6.2 for more information about the Task Forces' discussion on disclosures.

#### B-5.3 Professional Skepticism

66. The Task Force discussed several options of how to enhance a skeptical mindset in the response to the assessed risks of material misstatement of an accounting estimate. One of the options discussed would be to add a new requirement in which the auditor needs to consider whether, in addition to the procedures in paragraphs 13–17, additional procedures are necessary to retain an attitude of professional skepticism, including when assessing contrary or inconsistent evidence. The additional requirement could be a reminder for auditors to maintain a skeptical mindset but it was also noted that professional skepticism is not created through a new requirement.
67. The Task Force discussed the initial drafting of paragraph 13 as included in the text box below, recognizing that it would also require the drafting of additional application material.

13. In responding to the assessed risks of material misstatement, as required by ISA 330,<sup>28</sup> and based on the auditor's understanding of how management makes the accounting estimate, the auditor shall undertake one or more of the following design and perform procedures responsive to the assessed risk of material misstatement, taking account of the nature of the accounting estimate recognizing that accounting estimates with higher estimation uncertainty require more persuasive audit evidence to be obtained to respond to the assessed risk of material misstatement. The auditor shall continue to accumulate audit evidence through performing these procedures (or alternative procedures that, in the auditor's professional judgement, are necessary to obtain sufficient appropriate audit evidence), until sufficient appropriate audit evidence has been obtained with respect to the accounting estimate: (Ref: Para. A59–A61)
- (d) Develop a point estimate or a range, either of the accounting estimate or of an element of the accounting estimate, to evaluate management's point estimate. For this purpose: (Ref: Para. A87–A91)
- (i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92)
- (ii) If the auditor concludes that it is appropriate to use a range, the auditor shall

<sup>28</sup> ISA 330, paragraph 5

narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93–A95)

- (new1) Develop an independent point estimate or range for key data or assumption to challenge management's choice of the key data or assumption. (Ref: TBA)
  - (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall ~~evaluate~~ challenge whether: (Ref: Para. A68–A70)
    - (i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71–A76)
    - (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77–A83)
  - (c) Test the operating effectiveness of the controls, including controls which may affect management bias, over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84–A86)
  - (new2) If management use a third-party in making the accounting estimate, testing the operating effectiveness of controls, including controls at the entity or at the third party that may have the effect of mitigating management bias, together with appropriate substantive procedures. (Ref: TBA)
    - (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62–A67)
14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence. (Ref: Para. A96–A101)

#### **Further Substantive Procedures to Respond to Significant Risks**

##### *Estimation Uncertainty*

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330,<sup>29</sup> the auditor shall evaluate the following: (Ref: Para. A102)
- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103–A106)
  - (b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107–A109)

<sup>29</sup> ISA 330, paragraph 18

- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)
16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111–A112)

#### **Matters for IAASB Consideration**

8. The IAASB is asked to comment on the discussion above, particularly:
- a. Whether the options that link the work effort closer to the identified risks of material misstatement should be further investigated?
  - b. Whether the IAASB believes that the development of ranges is always a useful way of obtaining sufficient appropriate audit evidence, in light of the concerns noted by auditors?
  - c. Whether the requirement in paragraph 16 could be altered to include alternative procedures to developing a range?
9. The IAASB is asked to provide views on the draft amendments to paragraph 13.

## **Section B-6: Other considerations**

### **B-6.1 Using the Work of Others**

#### *Third-Party Data Sources*

68. The Task Force discussed the use of third-party data sources, such as those management may use to obtain data on prices, market data, market participant assumptions, and economic data, amongst other things.
69. The use of third-party data sources has been an area where the IAASB has considered the issuance of 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 a third-party data source, was approved the IAPN 1000 Task Force acknowledged that amendments to the application material in ISA 500 and ISA 540 may be needed relative to an entity's use of third-party data sources. At the time, the Task Force withdrew the proposed amendments in light of uncertainty about the circumstances surrounding the use of third-party data sources.
70. In this ISA 540 project, this matter was raised in the outreach performed by the 540 Task Force. Third-party data are used to either provide management with a number that management uses in making an accounting estimate or to verify a valuation or assumption that management uses. In some cases management may also use a third party's model to calculate an accounting estimate.
71. The Task Force is of the view that ISA 540 can be strengthened by including guidance about the auditor's work effort to evaluate whether the third-party's work is appropriate to use as audit evidence

for the relevant assertion, and the auditor's work effort thereon. The Task Force will take the following into account:

- The auditor needs to understand why and how management uses a third-party data service, as well as why management cannot or does not generate the prices itself. Through the understanding obtained the auditor might be able to better understand which procedures need to be performed in order to rely on the data received from the third-party.
- Third-party data sources often do not allow the auditor access to the systems, processes and algorithms used because of confidentiality issues.
- Data from third-party data services often has a relatively low chance of being affected by management bias as the third-party data sources provide the same prices for a large range of clients.
- The work effort of the auditor when the third-party data sources provide management with a price range and management selects one point in that range.
- Whether management has considered alternative data.

**Matter for IAASB Consideration**

10. The IAASB is asked for its views on the inclusion of additional material on third-party data sources in ISA 540 and, where applicable, in ISA 500.

*The Auditor's Use of the Work of Experts in Auditing Accounting Estimates*

72. In future Task Force discussions, the Task Force will explore whether the requirements and application material can be enhanced in relation to the work of experts when dealing with accounting estimates. This matter will be brought to a future IAASB meeting. For information, initial discussions have focused on, in the circumstance when the audit engagement involves highly complex accounting estimates, the level of competence and capabilities needed:

- (a) By the engagement team in order to be able to obtain a sufficient understanding of the field of expertise of the auditor's expert and to evaluate the adequacy of the auditor's expert's work for the auditor's purposes; and
- (b) By the engagement partner, in order to be able to be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to: (i) perform the audit engagement in accordance with professional standards and applicable legal and regulatory requirements; and (ii) enable an auditor's report that is appropriate in the circumstances to be issued (see paragraph 14 of ISA 220).<sup>30</sup>

**B-6.2 Disclosure Considerations**

73. Paragraph 19 and 20 of ISA 540 include requirements in respect of disclosures related to accounting estimates. As discussed in section B-5.2 the Task Force is of the view that, given that disclosures can provide users an understanding of the estimation uncertainty, especially for accounting estimates

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<sup>30</sup> ISA 220, *Quality Control for an Audit of Financial Statements*

with a high estimation uncertainty, the auditor's work effort on accounting estimate disclosures is critical to a high quality audit.

74. The Task Force discussed paragraph 20 of ISA 540, which requires the auditor to evaluate the adequacy of the disclosures of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. Given the increased focus on disclosures of estimation uncertainty, the Task Force was of the view that ISA 540 could be strengthened by enhancing the auditor's work effort on disclosures, particularly for accounting estimates with high estimation uncertainty but also for accounting estimates more broadly.

#### **Matter for IAASB Consideration**

11. The IAASB is asked for its views whether the auditor's work effort on disclosures related to accounting estimates (particularly for accounting estimates with high estimation uncertainty but also for accounting estimates more broadly) should be strengthened.

### **B-6.3 Auditor Reporting Implications**

75. With the new auditor reporting standards, including the requirement to communicate key audit matters, becoming effective for audits of financial statements for periods ending on or after December 15, 2016, auditors will soon have another option to highlight their work on accounting estimates, if it meets the definition of a key audit matter.
76. The Task Force discussed whether a new requirement or application material should be included in ISA 540 that would emphasize that accounting estimates with a high estimation uncertainty could be a key audit matter given its importance to the user's understanding of estimation uncertainty. However, it was also noted that accounting estimates with a high estimation uncertainty are already specifically mentioned in paragraph 9(c) of ISA 701<sup>31</sup> and that adding an additional requirement or application material could interfere with the chain of logic as described in ISA 701. The Task Force will consider this matter further in Q2, 2016.

### **Section C: Way Forward**

77. After the March 2016 meeting the Task Force will continue its deliberations on issues related to ISA 540. The discussion will include issues that have not been discussed till date including but not limited to:
- Testing controls around the data that comes from systems that have traditionally not been part of the financial reporting process; and
  - The auditor's use of the work of experts in auditing accounting estimates.
78. The Task Force will also focus on drafting amended and new requirements and application material and continue to work on the issues that have been included in this paper. The Task Force will, at a later stage, determine whether non-authoritative guidance and support tools, such as IAPNs, Staff publications, project updates or other materials should be developed to address special audit considerations relevant to financial institutions to supplement the revisions to ISA 540 and oversee the development of the guidance material considered necessary.

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<sup>31</sup> ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*



## Summary of ISA Implementation Monitoring Findings Related to ISA 540

### Introduction

1. In March 2009, the IAASB completed its Clarity Project designed to improve the clarity and understandability of the International Standards on Auditing (ISAs) and International Standard on Quality Control 1 and, thereby, facilitate their consistent application. In addition to improving the clarity, the IAASB substantively revised approximately half of the ISAs. Subsequently the Board agreed to a post-implementation review of the clarified ISAs, and certain recently revised ISAs, to determine whether there is a need for further refinement of those standards. The IAASB published a report called “The Clarified ISAs—Findings from the Post-Implementation Review” in July 2013.<sup>32</sup>

### ISA 540

#### *Goals for the Revised and Redrafted ISA 540*

2. As part of the clarity project ISA 540 was revised and redrafted with the following goals:
  - a) To strengthen auditor rigor in auditing accounting estimates, including fair value accounting estimates, and related disclosures;
  - b) To assist the auditor in applying the ISAs’ risk-based approach to the audit of accounting estimates, in particular by focusing on the degree of estimation uncertainty and designing appropriate responses to it; and
  - c) To emphasize the importance of professional skepticism and ensure that attention is paid to indicators of possible management bias and their audit implications.

#### *Findings related to ISA 540*

3. The ISA Implementation Monitoring Findings report includes a prioritization of the issues identified in 3 categories; key, important, and other. All issues identified related to ISA 540 were classified in the “other” category which means that there is limited evidence that suggests that a change to the ISA may have merit. The issues raised by respondents are included in the appendix to this paper and can be summarized in the following 4 themes:

#### Risk assessment procedures

4. Some respondents<sup>33</sup> expressed concern that:
  - It is not clear to which estimates the requirements in ISA 540 are intended to apply (e.g., it was noted that many amounts appearing in financial statements are now estimates and applying the requirements of ISA 540 to all estimates is likely to be impractical); and

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<sup>32</sup> <http://www.ifac.org/publications-resources/clarified-isas-findings-post-implementation-review>

<sup>33</sup> KPMG IFRG Limited, Canadian Public Accountability Body Canadian Auditing and Assurance Standards Board, Instituto Dos Auditores Independentes Do Brasil

- There is inconsistency in the work effort around obtaining an understanding of the estimate, including the underlying data, the model used, internal consistency of management assumptions used and how management has assessed estimation uncertainty.

#### Applying ISA 540 to certain accounting estimates

5. There is a wide variety of accounting estimates in contemporary financial statements. Some respondents<sup>34</sup> have called for more specific audit guidance to assist with the application of the requirements of ISA 540 to some of the more complex accounting estimates arising from application of the financial reporting standards, such as loan loss provisioning, valuation of certain financial instruments, and goodwill impairments.

#### Work effort on management assumptions

6. A few respondents<sup>35</sup> noted an inconsistency in the work effort on management's assumptions used in calculations of estimates, including work on whether management had considered alternative assumptions or outcomes.

#### Relationship between estimates and significant risks

7. A few respondents<sup>36</sup> believed that a stronger link needs to be made between estimates with a high degree of estimation uncertainty and the existence of a significant risk.

#### *Other comments*

8. In addition to the comments summarized above the following other, isolated, comments were raised:
  - Importance of including accounting estimates in the financial statements that are used in the calculation of banks' regulatory capital measures in the list of indicators of potential management bias;<sup>37</sup> and
  - Include more guidance on the circumstances under which a combination of responses, as included in paragraph 13, is appropriate.<sup>38</sup>

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<sup>34</sup> European Audit Inspection Group, HLB International, CPA Australia, BDO International, Independent Regulatory Board for Auditors (South Africa)

<sup>35</sup> Canadian Public Accountability Board, South African Institute of Chartered Accountants

<sup>36</sup> Canadian Public Accountability Board, Financial Reporting Council (United Kingdom)

<sup>37</sup> Basel Committee on Banking Supervision

<sup>38</sup> Canadian Public Accountability Board