

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

Draft Minutes – March 2016 IAASB Meeting

Mr. Sharko and Mr. Pickeur introduced the topic by highlighting the feedback received from the IAASB Consultative Advisory Group (CAG) Representatives and Observers and the Task Force's activities since the December 2015 IAASB meeting. These activities include, among others, the release of the Project Publication,¹ discussions of relevant issues, and the continued outreach efforts with a specific focus on audits of non-financial institutions.

In general the Board noted support for:

- Including throughout ISA 540, in addition to the degree of estimation uncertainty, a specific focus on complexity as the Board was of the view that both factors are important to consider in determining the risk of material misstatement when auditing accounting estimates.
- Emphasizing and clarifying the scalability of ISA 540 when dealing with simpler accounting estimates while keeping the requirements and guidance on auditing accounting estimates in one standard. The Board was generally supportive of the suggestions proposed by the Task Force regarding how the scalability of ISA 540 can be emphasized.
- Further work on third party data sources, including emphasizing the distinction between third party data sources and a management's expert and explaining the auditor's work effort on data used by a third party source. It was noted that the Task Force would perform further work on this topic with respect to auditing accounting estimates and would not embark in the revision of ISA 620.²
- Strengthening the application material with respect to obtaining an understanding of models by describing in more detail the matters that an auditor may address when establishing or validating a model including the governance structure and controls around model development.
- Strengthening the application material with respect to the auditor's responsibilities when management's point estimates falls within the range the auditor's considers to be reasonable but the auditor's range is larger than performance materiality.
- The Task Force to continue focusing on the implications for disclosures of accounting estimates, especially for accounting estimates with a high estimation uncertainty.

The Board asked the Task Force to consider:

- Various suggestions regarding the approach to enhance professional skepticism throughout the standard, including how to auditor should consider contradictory audit evidence, emphasize professional skepticism through the wording used in ISA 540, and clarifying what 'reasonable' means in paragraph 13(d)(ii) of ISA 540.

¹ <http://www.ifac.org/system/files/publications/files/IAASB-ISA-540-Project-Publication.pdf>

² ISA 620, *Using the Work of an Auditor's Expert*

- Whether clarification of the terms “governance” and “key data and assumptions” are needed, as these terms are not currently used in the ISAs.
- How the concept of retrospective review can be applied for accounting estimates that have high estimation uncertainty and a lengthy duration.
- Finding another way of emphasizing the spectrum of risk and appropriate responses as, generally, the Board was not supportive of including a rebuttable presumption that all accounting estimates with a high estimation uncertainty are a significant risk. It was noted that the Task Force needs to consider how best to respond to regulatory concerns that expected credit loss models are always a significant risk and to focus on the work effort on accounting estimates that do not give rise to a significant risk but are relatively close.
- Various drafting suggestions for paragraphs 8, 8A, 10 and 13 that were presented to the Board in the **Agenda Item 4-A**. In broad terms, there was support for paragraph 10 and noted, with respect to paragraph 13, that the requirement should be more granular, be more like a menu of options that the auditor needs to consider, and include new procedures that are more aligned with today’s audit environment. However, the Task Force needs to find a way to express the relationship between the risks and related work effort using terms and concepts already present in the ISAs. The Board also questioned the practicality of some of the new procedures that the Task Force proposed in paragraph 13 would work in practice and therefore asked the Task Force to consider the options proposed.
- The need to emphasize that the auditor cannot reduce estimation uncertainty. It was also noted that the Task Force should consider how the auditor can further address estimation uncertainty in the audit.
- With respect to disclosures, whether there is merit in developing material for cases when the financial reporting framework does not require disclosures about estimation uncertainty for an accounting estimate with a high estimation uncertainty.

DISCUSSION WITH OTHER WORKING GROUPS

During the Board meeting the ISA 540 Task Force had a joint meeting with the Professional Skepticism Working Group (PSWG), ISA 315³ (Revised) Working Group and the Data Analytics Working Group (DAWG) to discuss common issues, how these working groups can assist the ISA 540 Task Force, and how to liaise going forward.

The discussions highlighted that the PSWG may need to accelerate its discussions on how best to enhance professional skepticism within ISA 540 in order to provide the ISA 540 Task Force with needed input. In that respect, it was also noted that the IAASB representatives on the working group may need to progress their thinking separately from the other Professional Skepticisms Working Group members from other Boards. Specific areas for consideration for the PSWG included how to build the impact of professional skepticism on risk assessment into ISA 540, the role of professional skepticism in considering contradictory audit evidence and weighing audit evidence, and what knowledge of the business model is needed to be able to demonstrate professional skepticism in challenging

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

management. In addition, the PSWG was asked to consider with which mindset practitioners should apply the International Standards; a neutral, open or challenging mindset.

With regard to ISA 315 (Revised), it was recognized that the ISA 540 Task Force will have to progress based on extant ISA 315 (Revised) and that the ISA 540 Task Force should consider how the link between ISA 315 (Revised) and ISA 540 can be strengthened to avoid repetition and to better align language. The ISA 540 Task Force and the ISA 315 Working Group identified key areas for interaction that include (i) whether the current significant risk model will continue to exist, (ii) what areas of understanding the entity and risk assessment procedures could be enhanced in ISA 540, and (iii) which standard should address the requests for more controls (including general IT controls), governance over models, data and estimation processes.

The DAWG and ISA 540 Task Force noted less interactions are needed between these groups due to the early phase of the DAWG's discussions. The DAWG will provide the ISA 540 Task Force with areas in which material could be included in ISA 540 with respect to data analytics. It was also recognized that nothing in the current ISAs prohibits the use of data analytic techniques.

PIOB OBSERVERS REMARKS

Mr. van Hulle noted that the word governance is often used in financial institution in relation to models and highlighted the importance of using wording that is also widely understood to financial regulators so they can better relate to the International Standards. He also suggested to perform further work on the auditor's bias that might exist in using a model that the audit firm has developed, and in situations where the financial institution's auditor is asked to validate a model that is used by the financial institution.

IAASB CAG CHAIRMAN REMARKS

Mr. Waldron highlighted the CAG's support for emphasizing and clarifying the scalability of ISA 540 when dealing with simpler accounting estimates while keeping the requirements and guidance on auditing accounting estimates in one standard. He furthermore noted the CAG's support to strengthen the use of professional skepticism in ISA 540 and explained the difference views on how best to do this. Finally he noted that the CAG was of the view that the changes made to ISA 540 should keep the standard principle based.

WAY FORWARD

The Task Force will present relevant issues to the IAASB at its June 2016 meeting. The Task Force will also continue its outreach with, among others, the IAASB CAG, the International Federation of Accountants' Small and Medium Practices Committee (SMP Committee) and other stakeholders in various industries, and will also continue its liaison with the Chairs of the PSWG, ISA 315 Working Group and DAWG.

Objective of the IAASB Discussion

The objective of the IAASB discussion at its June 2016 meeting is to receive input on the ISA 540 Task Force's (the Task Force) proposed responses to selected issues and related proposed amendments to ISA 540.

Section A: Introduction

Recent Outreach

1. Since the March 2016 IAASB meeting, the Task Force has continued its outreach with stakeholders outside the financial institution industry to identify issues specific to non-financial institutions. The Task Force and IAASB leadership had meetings with the International Forum of Independent Audit Regulators, the International Accounting Standards Board, SMP Committee, the Confederation of Netherlands Industry and Employers (VNO-NCW) and audit teams in Switzerland and Canada that, respectively, audit a pharmaceutical and a mining company. The meetings highlighted the fact that most issues identified as part of the Task Force's outreach with financial institutions are also applicable to non-financial institutions.
2. The Task Force also continued its outreach with financial institutions and had meetings with the Basel Committee on Banking Supervision's Auditing Expert Group, the International Association of Insurance Supervisors' Accounting and Auditing Working Group and the Dubai Financial Services Authority, and participated in the Institute of International Finance's Three-Way Dialogue in which banking regulators, accounting standard setters and the banking industry discuss key issues in the banking industry in the area of international accounting.
3. The Task Force plans to continue its outreach activities, although less outreach is expected to be needed in the second half of 2016.

Interactions with IAASB Working Groups

4. Following the initial joint working group meeting between the ISA 540 Task Force, the PSWG and the ISA 315 Working Group, the ISA 540 staff and leadership have continued liaison activities on matters of mutual interest.
5. This included teleconferences with the PSWG leadership and staff to discuss the role of professional skepticism in ISA 540. There were also specific requests for the PSWG to consider whether the concept of contradictory evidence could be better developed, and whether the definition of management bias should be placed earlier in the ISAs rather than in ISA 540.
6. Regarding ISA 315, the ISA 540 Task Force has noted that continued strong interactions will be needed due to the degree of overlapping issues. The Task Force notes that, as the intended issuance of ISA 540 (Revised) will likely predate the issuance of ISA 315 (Revised), ISA 540 (Revised) must be capable of working with extant ISA 315 (Revised), while ensuring that there are sufficient "hooks" in proposed revised ISA 540 to allow it to operate under any revised ISA 315 (subject to any conforming amendments necessary).

Structure of This Paper

7. This paper is structured as follows:
 - a) Introduction and Scope (see Section B-1)
 - b) Definitions (see Section B-2)
 - c) Risk Assessment (see Section B-3)
 - d) Response to Identified Risks of Material Misstatement (see Section B-4)
 - e) Way Forward (see Section B-5).
8. The sections below include, in some places, drafting that has been prepared for the Task Force's consideration in developing its thinking, to enable the IAASB to better understand that thinking and the Task Force's initial proposals. Importantly, the Task Force has not been able to fully consider all the new and revised application material included below, nor has it been possible in the timeframe to draft all application material that may be needed, although areas where additional application material will be needed have been flagged. These initial proposals are likely to develop further as the Task Force moves forward with its work.

Matter for IAASB Consideration

1. At the beginning of the IAASB's discussion, each member will be asked to provide an overview of their reactions to the papers presented, and to highlight areas that they particularly wish to discuss. This will enable the Task Force leadership to better allocate the available time.

Section B-1: Introduction and Scope

Application of ISA 540 for Simple Estimates

9. At the March 2016 IAASB meeting, the IAASB generally supported retaining the existing approach in ISA 540, whereby all accounting estimates are dealt with by ISA 540, as opposed to focusing ISA 540 on more complex estimates, with other estimates either being dealt with by a separate standard or by the rest of the ISAs.
10. Accordingly, the Task Force has drafted a new paragraph for the introduction section of the standard to highlight how the ISA is applied to the range of estimates that exist, which notes that the application material intended for accounting estimates that are more complex or have higher estimation uncertainty may not be relevant in the case of an estimate with low estimation uncertainty and little complexity. However, an auditor must still comply with each relevant requirement unless conditional and the condition does not exist.

Application to Accounting Estimates with Low Estimation Uncertainty and Complexity

- 4A. This ISA applies to all accounting estimates. Accounting estimates have different levels of estimation uncertainty and complexity. Estimation uncertainty and complexity are distinguishing characteristics of accounting estimates that affect the determination of the risk of material misstatement of such estimates. In dealing with accounting estimates with low estimation uncertainty and little complexity, the application and other explanatory material in this ISA related to accounting estimates with higher estimation uncertainty and complexity may not be relevant.

Matter for IAASB Consideration

2. The IAASB is asked for its views on draft paragraph 4A above.

Incorporation of the Concept of Complexity

11. At the March 2016 IAASB and CAG meetings, there was support for more explicitly including the concept of complexity within ISA 540. This will require a series of changes throughout the ISA, which have been incorporated into the draft amendments as appropriate.

Application of the ISA to Individual Accounting Estimates

12. During its deliberations, the Task Force noted that it was, at times, difficult to determine whether parts of the standard were intended to apply to the entity's accounting estimates as a whole, or whether a particular requirement was intended to be applied to an individual financial statement item. In this respect, the Task Force noted various uses of the singular and plural form of "accounting estimate" in ISA 540 and uses of both the definite ("the accounting estimate") and indefinite articles ("an accounting estimate").
13. The Task Force believes that the standard should be clear on whether a requirement is intended to be applied to the accounting estimates as a whole or to an individual accounting estimate. The Task Force will continue to investigate how best to do this, but the preliminary conclusion is that the plural form should be used when referring to accounting estimates in general, and "the accounting estimate" be used when dealing with a specific accounting estimate.

Matter for IAASB Consideration

3. The IAASB is asked for its views on whether certain requirements should be addressed to individual accounting estimates rather than accounting estimates more generally.

Section B-2: Definitions

14. ISA 540 contains six defined terms, some of which will need to be revised in light of changes elsewhere in the ISA. During the Task Force's discussions, it was also noted that defining terms such as "method," "model," "data," and "assumptions" may be necessary given the extent to which these term are likely to be used in the revised ISA. Accordingly, the Task Force has prepared some working definitions to ensure that terms are used consistently and appropriately throughout the ISA as the revision of ISA 540 progresses.
15. Paragraphs 47–48 of IAPN 1000⁴ describes "model," "data," and "assumptions" as follows:
 47. Models may be used to value financial instruments when the price cannot be directly observed in the market. Models can be as simple as a commonly used bond pricing formula or involve complex, specifically developed software tools to value financial instruments with level 3 inputs. Many models are based on discounted cash flow calculations.

⁴ International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

48. Models comprise a methodology, assumptions and data. The methodology describes rules or principles governing the relationship between the variables in the valuation. Assumptions include estimates of uncertain variables which are used in the model. Data may comprise actual or hypothetical information about the financial instrument, or other inputs to the financial instrument.
16. The Task Force notes that the descriptions in IAPN 1000 are not definitions, but they served as useful starting points to the Task Force's deliberations related to developing definitions.
17. The Task Force's recommendations for the definitions needed in ISA 540, and the Task Force's rationale for the changes, follow.

Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Accounting estimate – ~~An approximation of a~~ monetary amount prepared in accordance with the requirements of the applicable financial reporting framework, the measurement of which cannot be observed directly and can only be estimated in the absence of a precise means of measurement. An accounting estimate is subject to estimation uncertainty. The amount may be required to be recognized or disclosed in the financial statements, or may be used to decide whether to recognize or disclose a financial statement item. 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 this ISA addresses only accounting estimates involving measurement at fair value, the term "fair value accounting estimates" is used. (Ref: Para. AX1)
 - (b) Auditor's point estimate or auditor's range – ~~The~~ An amount, or range of amounts, respectively, identified or developed by the auditor, derived from audit evidence for use in evaluating management's point estimate. (Ref: Para. AX2)
 - (c) Estimation uncertainty – The susceptibility of an accounting estimate ~~and related disclosures to~~ an inherent lack of precision in its measurement. (Ref: Para. AX3)
 - (d) Management bias – A lack of neutrality by management in the preparation of information.
 - (e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
 - (f) Outcome of an accounting estimate – The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by ~~the~~ an accounting estimate. (Ref: Para. AX4)
- 7A. For purposes of this ISA, the following terms have the meanings attributed below:
- (a) Assumption – An [input]⁵ to an estimation process other than data. An assumption is selected by management from a range of possible alternatives for use in applying a method to make an accounting estimate. (Ref: Para. AX5–AX7, AX10–AX11)
 - (b) Complex model – A model that exhibits a significant degree of complexity in its design or

⁵ The usage of the term "input" in this paragraph will be reevaluated by the Task Force to ensure the term is consistently used throughout the ISA.

operation.

- (c) Data – Comprises factual data, which is information that can be observed, and derived data, which is information obtained through applying analytical or interpretive techniques to factual data. (Ref: Para. AX8—AX11)
- (d) Method – The technique used by management to make the accounting estimate. A method may be applied using a model or other calculations and specifies the types of data and assumptions, and set of relationships between them, which are to be used to make the estimate.
- (e) Model – A system or tool used to make an accounting estimate. A model applies the assumptions and data, and a set of relationships between them, as specified by the method used to make the accounting estimate. A model may also be used to develop an assumption.

Accounting Estimate

AX1. Accounting estimates may be account balances recognized in the financial statements, but also include accounting estimates used in disclosures or used to make judgments about whether or not to recognize or disclose a monetary amount.

Auditor's Point Estimate or Auditor's Range

AX2. The auditor may wish to develop a point estimate or range over for the whole accounting estimate, a subset of the accounting estimate (for example, a particular loan portfolio or set of financial instruments), or an item of data or an assumption (for example, the probability of default assumption).

Estimation Uncertainty

AX3. Estimation uncertainty comes from several sources, including:

- Measurement techniques required or permitted by the applicable financial reporting framework; and
- Limitations in data and analytical techniques.

Estimation uncertainty is an inherent characteristic of accounting estimates and cannot be reduced by the application of auditing procedures.

Outcome

AX4. Some estimates, by their nature, do not have an outcome as defined by this ISA. For example, a fair value measurement is based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or the liability transferred may differ from the fair value accounting estimate because, for example with the passage of time, the perceptions of value may change.

Assumption

AX5. Assumptions may include matters such as the choice of an interest rate, an algorithm, or judgments about future conditions or events.

AX6. The applicable financial reporting framework often provides criteria or guidance to be used in the selection of an assumption. For example, a discount rate is usually an assumption to a model, as the use of a different discount rate could be selected based on judgment within any boundary set by the applicable financial reporting framework. An assumption can also be the choice of one algorithm (such as a bond pricing formula) over another algorithm.

AX7. Risks of material misstatement associated with assumptions include that an inappropriate or unreasonable assumption could be selected in light of the applicable financial reporting framework. For example, if the applicable financial reporting framework calls for the use of a discount rate that a market participant would use, the selection of a discount rate based on the entity's own cost of capital would not be appropriate, unless it approximates what a market participant would use.

Data

AX8. The selection of which data to use in an accounting estimate may require judgment about the relevance and reliability of the data or the reputation of the source of the data. Examples of data include market prices or data included in contracts (for example, for a loan the data may include the contracted interest rate, payment schedule, and term of the contract).

AX9. It is possible to make some generalizations about the relevance and reliability of data to be used in making an accounting estimate:

- The data may not be relevant for the use to which it is being applied. For example, the data regarding a market for a particular item may not be relevant for a market for a different item unless the two markets are similar and the differences between the markets can be addressed using a commonly accepted formula or assumption. This may be the case when dealing with bond prices where it is common practice to extrapolate pricing data for a bond based on the trading data of other bonds;
- Data obtained from reputable sources is likely to be more reliable than other data;
- Controls over data may improve the reliability of the data; and
- Data may be more reliable when it is widely available (and therefore, subject to greater scrutiny). However, in some cases, the opposite may be true – for example, some market participants may have better data than is publicly available due to their ability to better observe the operation of the market.

Distinguishing between Derived Data and Assumptions

AX10. While developing an assumption involves the exercise of judgment in selecting from a range of possible alternatives, developing derived data⁶ does not. Derived data is obtained through applying analytical and other objective interpretive techniques to factual data. For example, if a particular model requires an assumption about an interest rate during a period commencing five years in the future and ending ten years in the future, the assumed rate may be selected from a number of alternatives such as (a) the current implied rates in various future money markets or an average of them or (b) predictions about changes in interest rates based on macro-economic data and

⁶ Where the remainder of this ISA refers to "data," this is intended to mean both factual data and derived data, unless stated otherwise

trends published by experts. The current implied rates or their average would be derived data (as they are determined from factual data about current five- and ten-year money rates in those markets by interpolating what those rates imply for the future interest rate in each of the next two five-year periods). The assumption would be the rate selected, which might be the derived rates from (a) or the predicted rates in (b).

AX11. Professional judgment is needed to determine whether a particular [input] to a model is data or an assumption. Data for one model could be considered an assumption for another model. Regardless of whether the auditor determines that a particular [input] is data or an assumption, the auditor may need to consider what could go wrong with the [input].

Accounting Estimate

18. The Task Force notes that the definition of an accounting estimate needs to address, in addition to amounts recognized or disclosed, decisions regarding whether or not to recognize the accounting estimate, or whether to make a related disclosure. The Task Force also proposes changes to better align the definitions with terms and phrases in a prominent financial reporting framework (International Financial Reporting Standards (IFRS)).
19. Decisions regarding whether to recognize a financial statement item are required by some financial reporting frameworks and sometimes require the calculation of an accounting estimate. The Task Force did not see a reason to treat the uses of accounting estimates in these cases in a wholly different manner to accounting estimates that are financial statement items – albeit with a need to recognize that the disclosure requirements may differ.
20. The Task Force has also sought to bring in elements of the phrase used in IFRS to describe “measurement uncertainty”: into the definition: *“One factor affecting the relevance of financial information is the level of measurement uncertainty. Measurement uncertainty arises when a measure for an asset or a liability cannot be observed directly and must instead be estimated. The use of estimates is an essential part of the preparation of financial information and does not necessarily undermine its relevance, but the estimate needs to be properly described and disclosed”*⁷ [emphasis added].
21. The Task Force also believes that it is important for the definition to draw an unambiguous link with estimation uncertainty as this is central to the nature of an accounting estimate.

Auditor’s Point Estimate or Auditor’s Range

22. The Task Force believes that the definition of an auditor’s point estimate or auditor’s range should now cover not only amounts or ranges developed by the auditor to compare with the accounting estimate as a whole, but also such amounts or ranges developed to compare with 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 – for example, the expected credit losses on a portfolio of automobile loans rather than the whole loan portfolio. The new paragraph AX2 proposed above is intended to lay some of the groundwork for

⁷ See IFRS Conceptual Framework Exposure Draft, www.ifrs.org/Current-Projects/IASB-Projects/Conceptual-Framework/Documents/May%202015/ED_CF_MAY%202015.pdf

addressing this, but the Task Force intends to consider further whether a change to the definition or additional application material may be needed.

Estimation Uncertainty

23. In light of the Task Force's proposal to include disclosed accounting estimates in the definition of an accounting estimate, the phrase "and related disclosures" is not needed in the definition of estimation uncertainty. New application material has also been drafted to explain some of the sources of estimation uncertainty.

Management Bias

24. While this definition has not changed for the moment, the Task Force is liaising with the PSWG about whether this definition belongs in ISA 540, whether it should be relocated elsewhere in the ISAs, and whether the definition should be revised.

Management's Point Estimate

25. The Task Force has expressed various views on whether this definition continues to be of use. On one hand, having such a definition could make it easier in certain paragraphs to explain the relationship between point estimates developed by the auditor and those developed by management.⁸ The contrary view is that the definition does not add much to what the phrase "management's accounting estimate" would ordinarily mean. The Task Force proposes to consider this further as the drafting of the work effort paragraphs in the standard continues.

Outcome of an Accounting Estimate

26. This definition is closely linked to the discussion on the retrospective review (see paragraphs 51–52). The Task Force proposes no changes to the definition at this time, but has proposed new application material that explains when an accounting estimate is unlikely to have an "outcome" as defined – such as with fair value accounting estimates when market participants' perspectives have changed in the intervening period.

New Definitions

27. As noted above, the Task Force believes defining some terms used throughout ISA 540 will aid comprehension of the ISA. In addition to the new definitions, the Task Force has also drafted some application material to clarify certain challenges that are encountered by practitioners.
28. It is acknowledged that arriving at precise and widely-agreed definitions of terms such as method, model, data, and assumptions is difficult, if not impossible. In light of this, the Task Force has sought input from a practitioner in the valuations space, as well as made reference to the extensive outreach conducted to date. The Task Force believes that the need for clarity in ISA 540 demands that the Board, at least, should be precise in what it means when it uses the terms while developing the Exposure Draft. It is possible that, upon reflection once the drafting is complete, not all the additional definitions will be needed.

⁸ For example, paragraph 13(d) of extant ISA 540 begins with "*...the auditor shall...develop a point estimate to evaluate management's point estimate.*"

29. In arriving at these definitions, the Task Force believed that it was important that the definitions be understandable to all auditors. While some auditors are experts in complex valuations and some may have a deep conceptual understanding of the nature of the items being estimated, many auditors may not have specific expertise in these areas. Accordingly, while the Task Force explored a number of alternatives, the Task Force considered it important to develop relatively simple definitions rather than approaches that were seen to be too conceptual, too mathematically based, or too lengthy. While recognizing that there may be more technical and complex ways to define these terms, the Task Force believes that it has arrived at pragmatic definitions that are appropriate for use in ISA 540.
30. The terms are defined solely for the purposes of ISA 540, as their use in other ISAs may be intended to be interpreted in a broader sense. It is acknowledged that conforming amendments may be needed to IAPN 1000.

Assumptions and Data

31. The definitions for assumptions and data are accompanied by new application material. After input from a valuations expert, it became clear that “data” is understood to include data not only actually observed but which also can be easily derived from observable data. This may occur, for example, For example:
 - a) There may be observable data about the payment timing and amounts for remaining capital and interest coupons and their market prices at a particular date. The implied interest rates over the remaining terms of those bonds can be derived from this data, by applying a commonly used formula; or
 - b) When there is no trading activity on a particular bond on a particular date, but there is trading on similar bonds and the expected or implied price of the untraded bond can be derived from applying a commonly used formula to interpolate the data.
32. Examples of assumptions include such items as a future interest rate, an algorithm, or judgments about future conditions or events. The need to select an assumption from a range of possible alternatives is central to the concept of an assumption. While there may be “data” to support the choice of an assumption, judgment is usually needed in making the selection as well as reference to the applicable financial reporting framework (which often gives guidance on the judgment to be made).
33. The Task Force’s discussions included whether “assumptions” should be more broadly defined to include other judgments made, such as the choice to use one method over an alternative. The Task Force concluded that such an approach would be difficult for auditors to comprehend, as it would require a broader definition of “assumption” than is commonly understood. Accordingly, other types of judgments not related to inputs selected from a range of alternatives for use in a method (or model) will be dealt with through separate requirements.
34. The Task Force acknowledges that it will, at times, be difficult to distinguish between data and assumptions. Accordingly, new application material has been drafted (see paragraphs AX9–AX10 above) to assist in this matter.

Method and Model

35. The Task Force believes that including definitions of both method and model in a revised ISA 540 will assist auditors in applying the new work effort. A significant amount of Task Force time has been spent on this, and various options and possible approaches have been explored.
36. Ultimately, and in line with extant ISA 540, the Task Force proposes defining method as the broader term to cover the technique used to make the accounting estimate. A model is one way to apply a method, but other approaches are possible.
37. For example, a depreciation calculation is likely to be a method as it has data (the historical cost of the asset), assumptions (the useful life of the asset and the expected scrap value), and a relationship between them (amortizing the cost over the useful life). By contrast, a model is a complex application of a method in that it is a “system or tool.” A system or tool could be as simple as a pricing formula commonly used for certain financial instruments to complex, specifically developed software tools. The Task Force has also proposed a definition of “complex model,” as it expects that this will be needed in the work effort requirements or application material.

Matter for IAASB Consideration

4. The IAASB is asked for its views on the new and amended definitions and the discussion thereon.

Section B-3: Risk Assessment

The Sensitivity of Accounting Estimates to Particular Data and Assumptions

38. In its March 2016 meeting, the Board generally supported the concept that the auditor should identify data and assumptions that have a “significant effect” on the accounting estimates. However, the Board 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, the Board questioned the term “significant” as it could be confusing given the concept of significant risk as included in ISA 315 (Revised).
39. Based on the Board’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 options, 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 factual or judgmental misstatements in using data and assumptions, in requirements relating to the risk assessment (paragraph 8(c)(vi)) and the identification of and assessment of the risk of material misstatement (paragraph 10(f)).

The Task Force was of the view that option (ii) 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 A51D).

Risk Assessment Procedures

Governance

40. In its March 2016 meeting, the IAASB asked the Task Force to consider whether clarification of the term “governance” is needed in respect of ISA 540, as this term is currently not defined in the ISAs.
41. The Task Force therefore performed further research to assess how the term governance is used and noted that the Glossary of Terms to the ISAs includes the following definition for governance: *‘Governance—Describes the role of person(s) or organization(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity.’*⁹ The Glossary of Terms also includes the term ‘Corporate Governance’ which has the same definition as “Governance”: *Corporate Governance—(see Governance)*.
42. The Task Force also researched how governance is defined by other organizations such as the Basel Committee on Banking Supervision, the Organisation for Economic Co-operation and Development and the Committee of Sponsoring Organizations, and concluded that most definitions of governance refer to governance at a strategic level. In the March 2016 issues paper, the Task Force used the term governance at a lower level (and therefore including higher-level controls amongst those that fall within the ambit of management, as well as oversight by those charged with governance); that is, as it relates to the oversight, review and control over the processes that generate an accounting estimate.
43. To avoid possible confusion between the usages of the term “governance”, the Task Force decided to use language similar to what is used in ISA 315 (Revised) and added the following in the risk assessment requirements relating to developing an understanding of the entity, to address the importance of oversight, review and control over the processes to make an accounting estimate:
 - The control environment relevant to making accounting estimates, including the review and approval of the accounting estimates by those charged with governance (paragraph 8(d)).
 - The entity’s activities to monitor controls over how the accounting estimates are made (paragraph 8(f)).
44. The application material to these new requirements explains the role of management and those charged with governance with respect to designing and implementing a system of internal control over accounting estimates, internal audit’s role in monitoring controls over how accounting estimates are made and the importance of adequate controls over the entities’ information system. It includes specific guidance on:
 - Matters that increase the risk of material misstatement because of insufficient oversight by those charged with governance (paragraph A38E);

⁹ According to the Glossary of Terms the term ‘governance’ is defined in the ISAs. Staff searched through the definition sections of the ISAs and did not identify this term and will investigate further if this term is denoted in the ISAs or not.

- 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 A38F);
- Circumstances when the review and approval of accounting estimates by those charged with governance may particularly be useful (paragraph A38G);
- 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 38I);
- How information systems serve as an important source of information for the quantitative and qualitative disclosures in the financial statements (paragraph A38J); and
- Areas where the work of the internal audit function may be particularly relevant (paragraph A38L).

Models and Data

45. As indicated in outreach and previous Task Force discussions, 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, complex models, and the use of data from external sources (including third-party 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.
46. In its March 2016 meeting, the IAASB was supportive of the Task Force's plan to strengthen the application material with respect to obtaining an understanding of data and models, whether it be management's own model or a third-party model, by describing in more detail the matters that an auditor may address when validating a model, including the entity's internal control around model development.
47. In response, the Task Force added application material in paragraph A28, which is based on paragraph 49 of IAPN 1000. 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.
48. To emphasize the importance of data, the Task Force added a new bullet under requirement 8(c) requiring the auditor to obtain an understanding of the data on which the accounting estimates are based, including whether such data has been obtained from internal or external sources, the nature and reliability of those sources and the processes applied in obtaining derived data. The application material includes matters that the auditor may consider in obtaining an understanding of the data on which the accounting estimates are based, in particular highlighting the importance of adequate controls around data in high volume environments.
49. In addition, the Task Force was of the view that showing the requirement to obtain an understanding of the relevant control activities (requirement 8(c)(ii)) as a separate bullet (paragraph 8(e)), instead of having it as a sub bullet of 8(c), would be more effective in drawing auditors' attention to the importance of obtaining an understanding of the controls related to the accounting estimates. The

Task Force expanded existing application material and enhanced the application material with respect to the use of models.

Other Changes to the Risk Assessment Procedures

50. In addition to the changes above, the Task Force also made the following changes to the requirements and application material:
- The Task Force aligned the introduction of paragraph 8 more closely with the objective of ISA 315 (Revised).¹⁰
 - The Task Force noted that almost all requirements in the risk assessment are based on inquiry of management and was of the view that the requirements could be enhanced by requiring the auditor to make an independent assessment of the sources that drive the accounting estimate's complexity and estimation uncertainty, and to obtain an understanding of the classes of transactions, account balances, and disclosures to be expected in the financial statements to which the estimates relates. The Task Force therefore included a new requirement (requirement 8(aA)), which is based on ISA 315 (Revised) paragraph 11, and related application material.
 - As discussed in paragraphs 38–39, the Task Force included the concept of the sensitivity of the accounting estimates to particular data and assumptions in the risk assessment (paragraph 8(c)(vi)), including related application material.

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 in applying~~ ISA 315 (Revised),¹¹ the auditor shall obtain an understanding of the ~~following in order~~ accounting estimates that is sufficient to provide a basis for the identification ~~identify~~ and assessment of ~~assess~~ the risks of material misstatement ~~for accounting estimates, whether due to fraud or error, at the financial statement and assertion levels. This understanding, includes~~ and determining whether any of the risks identified are, in the auditor's professional judgment, significant risks, thereby providing a basis for designing and performing further audit procedures in response to those risks. In doing so the auditor shall take into account: (Ref: Para. A12)
- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including the recognition principles, measurement basis and related disclosures. (Ref: Para. A13–A15)
- (aA) The nature of the accounting estimates, including the sources of complexity and estimation uncertainty and the classes of transactions, account balances, and disclosures to be expected in the financial statements to which the estimates relate. (Ref: Para. A15A–A15B)
- (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 management about changes in circumstances that may give rise to new, or the need to revise existing,

¹⁰ ISA 315 (Revised), paragraph 3

¹¹ ISA 315 (Revised), paragraphs 5–6 and 11–12

accounting estimates. (Ref: Para. A16–A21)

- (c) How management makes ~~the~~ accounting estimates, ~~and an understanding of the data on which they are based,~~ including: (Ref: Para. A22–A23)
- (i) ¹²The methods used in making the accounting estimates, how the methods have been applied and, where applicable, how models have been used in such application; ~~including where applicable the model,~~ (Ref: Para. A24–A26)——
- (iA) The data on which the accounting estimates are based, including whether data has been obtained from internal or external sources, the nature and reliability of those sources and the processes applied in obtaining the derived data; (Ref: Para. A26A–A26B)
- (i) ~~Relevant controls~~ (Ref: Para. A27–A28)
- (iv) The assumptions underlying the accounting estimates, including whether assumptions have been obtained from external sources; (Ref: Para. A31–A36)
- (iii) Whether management has used an expert; (Ref: Para. A29–A30)
- (vi) Whether and, if so, how management has ~~assessed~~addressed the effect of estimation uncertainty, including an assessment of which data and assumptions most influence estimation uncertainty and therefore have the greatest impact on the accounting estimate; and (Ref: Para. A38–A38A)
- (v) 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)
- (d) The control environment relevant to making accounting estimates, including the review and approval of accounting estimates by those charged with governance (Ref: Para. A38B–A38J)
- (e) The control activities relevant to making accounting estimates taking into account the methods used; and (Ref: Para. A26–A28)
- (f) The entity's activities to monitor controls over how accounting estimates are made. (Ref: Para. A38K–A38L)

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this ISA assist the auditor in developing an expectation of the nature and type of accounting estimates that an entity may have. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to identify and assess the risks of material misstatement in relation to accounting estimates, to determine whether any of those risks are significant risks, and to plan the nature, timing and extent of further audit procedures.

¹² The sub-paragraphs under (c) have been reordered and will be renumbered prior to publication.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework assists the auditor in determining whether it, for example:

- Prescribes certain conditions for the recognition,¹³ or methods for the measurement, of accounting estimates.
- Specifies certain conditions that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability.
- Specifies required or permitted disclosures.

Obtaining this understanding also provides the auditor with a basis for discussion with management about how management has applied those requirements relevant to the accounting estimates, and the auditor's determination of whether they have been applied appropriately.

A14. Financial reporting frameworks may provide guidance for management on determining point estimates where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.¹⁴ Others may require, for example, use of a discounted probability-weighted expected value to which a margin for risk and uncertainty could be added. In some cases, management may be able to make a point estimate directly. In other cases, management may be able to make a reliable point estimate only after considering alternative assumptions or outcomes from which it is able to determine a point estimate.

A15. Financial reporting frameworks may require the disclosure of information concerning the significant assumptions to which ~~the an~~ accounting estimate is particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit ~~certain~~ accounting estimates to be recognized in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of the Nature of the Accounting Estimates (Ref: Para. 8(aA))

A15A. Obtaining an understanding of the nature of the accounting estimate may assist the auditor in understanding whether the accounting estimate is complex to make or whether the accounting estimate has high estimation uncertainty because certain factors are present. For example, in order to make the accounting estimate, management may require complex models, or the accounting estimate may be based on data that is unobservable or complex, or is from outside the general and subsidiary ledgers. The accounting estimate may also have a long forecast period like some future cash flow predictions and is therefore susceptible to estimation uncertainty.

Obtaining an understanding of the nature of how the accounting estimate also provides the auditor with a basis for discussion with management about how management has made the accounting estimate, and the auditor's determination of whether the accounting estimate has been made appropriately in accordance with the applicable financial reporting framework.

A15B. The nature of the accounting estimate may give rise to specific risks of material misstatement. For example, an expected credit loss model may involve significant estimation uncertainty given the

long-term nature of the estimate and may require extensive modeling or large volume of data. In such cases, it is important that the engagement team includes members with sufficient relevant knowledge and experience.¹⁵

A15C. The auditor may consider whether information obtained from the auditor's previous experience with the entity and from previous audits provides useful information to understand the nature of the accounting estimate. For example, the auditor may have audited a similar accounting estimate in a previous audit and may therefore be aware if the accounting estimate is sensitive to particular data and assumptions.

[No changes to paragraphs A16–A21]

Obtaining an Understanding of How Management Makes the Accounting Estimates (Ref: Para. 8(c))

A22. The preparation of the financial statements also requires management to establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing ~~or identifying~~ relevant data and assumptions that affect the accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or transactions to which the accounting estimates relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognized measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Method of Measurement, Including the Use of Models (Ref: Para. 8(c)(i))

[No changes to paragraphs A24–A26]

¹³ Most financial reporting frameworks require incorporation in the ~~balance sheet~~statement of financial position or statement of profit or loss and other comprehensive income~~statement~~ of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognize such items, including accounting estimates.

¹⁴ Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

¹⁵ See paragraph 14 and ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14.

Data (Ref: Para. 8(c)(iiA))

A26A. In entities that use large volumes of data in making accounting estimates, effective, general IT controls and application controls may be necessary including controls over IT systems that maintain the integrity of information and the security of the data. Such systems process, including to ensure that data:

- Is completely and accurately extracted from the entity's records or obtained from appropriate third parties; and
- Flows completely and accurately through the entity's systems and that any modification to the data used in making the accounting estimate is appropriate. For example, an entity may find it necessary to translate data into a different currency.

A26B. Matters that the auditor may consider in obtaining an understanding of the data on which an accounting estimate is based include:

- The nature of the data.
- How management assesses whether the data is relevant and complete.
- Whether the data has ~~assumptions have~~ been obtained from internal or external sources, including the use of data from outside the general and subsidiary ledgers and the use of third-party data sources.
- The extent of reliance on information technology systems and the complexity resulting from the need for those systems to handle large volumes of data, including how the transactions or data are transmitted, processed, maintained or assessed electronically.

Management's Use of Experts (Ref: Para. 8(c)(iii))

[No changes to paragraphs A29–A30]

Assumptions (Ref: Para. 8(c)(iv))

A31. Assumptions are integral components of accounting estimates. Matters that the auditor may consider in obtaining an understanding of the assumptions underlying ~~an~~the accounting ~~estimates~~estimate include, for example:

- The nature of the assumptions, ~~including which of the assumptions are likely to be significant assumptions.~~
- How management assesses whether the assumptions are relevant and complete (that is, that all relevant variables have been taken into account).
- ~~Where~~When applicable, how management determines that the assumptions used are internally consistent.
- Whether the assumptions relate to matters within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and how they conform to the entity's business plans and the external environment, or to matters that are outside its control (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).

- The nature and extent of documentation, ~~if any~~, supporting the assumptions.

Assumptions may be made or identified by an expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A32. In some cases, assumptions may be referred to as inputs,¹⁶ for example, where management uses a model to make an accounting estimate, though the term inputs may also be used to refer to the underlying data to which specific assumptions are applied.

A33. Management may support assumptions with different types of information drawn from internal and external sources, the relevance and reliability of which will vary. In some cases, an assumption may be reliably based on applicable information from either external sources (for example, published interest rate or other statistical data) or internal sources (for example, historical information or previous conditions experienced by the entity). In other cases, an assumption may be more subjective, for example, where the entity has no experience or external sources from which to draw.

A34. In the case of fair value accounting estimates, assumptions reflect, or are consistent with, what knowledgeable, willing arm's length parties (sometimes referred to as "marketplace participants" or equivalent) would use in determining fair value when exchanging an asset or settling a liability. Specific assumptions will also vary with the characteristics of the asset or liability being valued, the valuation method used (for example, a market approach, or an income approach) and the requirements of the applicable financial reporting framework.

A35. With respect to fair value accounting estimates, assumptions or inputs vary in terms of their source and bases, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity (sometimes referred to as "observable inputs" or equivalent).
- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best information available in the circumstances (sometimes referred to as "unobservable inputs" or equivalent).

In practice, however, the distinction between (a) and (b) is not always apparent. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A36. The extent of subjectivity, such as whether an assumption or input is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.

Changes in Methods for Making Accounting Estimates (Ref: Para. 8(c)(v))

A37. In evaluating how management makes the accounting estimates, the auditor is required to understand whether there has been or ought to have been a change from the prior period in the

¹⁶ See footnote 3.

methods for making the accounting estimates. A specific estimation method may need to be changed in response to changes in the environment or circumstances affecting the entity or in the requirements of the applicable financial reporting framework. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework such changes. For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor challenges whether management's assumptions about the marketplace are reasonable in light of economic circumstances.

Estimation Uncertainty (Ref: Para. 8(c)(vi))

A38. Matters that the auditor may consider in obtaining an understanding of whether and, if so, how management has assessed the effect of estimation uncertainty include, for example:

- Whether and, if so, how management has considered alternative assumptions or outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the assumptions on an accounting estimate.
- How management determines the accounting estimate when analysis indicates a number of outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in the prior period, and whether management has appropriately responded to the outcome of that monitoring procedure.

A38A. Accounting estimates may be particularly sensitive to misstatements in certain data and assumptions. For example, an accounting estimate may be determined based on a model that has several assumptions, one of which particularly influences the outcome of the accounting estimate. The auditor may consider obtaining an understanding of how management identifies relevant data and assumptions to which the accounting estimate is particularly sensitive.

The Control Environment Relevant to Making Accounting Estimates (Ref: Para 8(d))

A38B. In some industries, such as the banking industry, the term governance may be used to describe something similar to what is meant by control environment in the ISAs.

A38C. The nature and extent of the entity's internal control over accounting estimates will vary depending on the size of the entity and the nature of its activities. For example, entities that have accounting estimates that require extensive reliance on information technology systems and use of large volumes of data may have more extensive internal control in place.

A38D. Management and, where applicable, those charged with governance are responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. An entity's internal control over accounting estimates is likely to be more effective when management and, where applicable, those charged with governance have:

- (a) Established an appropriate control environment, a logical organizational structure with clear assignment of authority and responsibility, and appropriate human resource policies and

procedures;

- (b) Established a risk management process relative to the size of the entity and the complexity of its accounting estimates (for example, in some entities a formal risk management function may exist);
- (c) Established information systems that provide those charged with governance with an understanding of the nature of the accounting estimates;
- (d) Designed, implemented and documented a system of internal control to:
 - (i) Properly present accounting estimates in the financial statements;
 - (ii) Ensure that the entity is in compliance with applicable laws and regulations; and
 - (iii) Monitor risk.
- (e) Established appropriate accounting policies in accordance with the applicable financial reporting framework.

Oversight by Those Charged with Governance

A38E. It is the role of those charged with governance to set the tone regarding, and approve and oversee, the process to make the accounting estimates. In addition, those charged with governance, together with management, are also responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework.

A38F. The risk of material misstatement may increase when those charged with governance:

- Do not fully understand the risks of using a particular model to make an accounting estimate or have insufficient skills and experience to assess the risk of, for example, the method or information technology used in making the accounting estimate.
- Do not have the skills and experience to challenge management in making an accounting estimate appropriately in accordance with the applicable financial reporting framework; or
- Do not have sufficient controls in place over the making of accounting estimates.

A38G. Depending on the nature of an accounting estimate, the auditor may consider obtaining an understanding of the extent of the review and approval of the accounting estimate, including any models used in its development, by those charged with governance, including:

- The existence of an appropriate authorization process for accounting estimates by those charged with governance, which is expected to be designed relative to the complexity and estimation uncertainty related to the accounting estimates.
- The monitoring activities over the accounting estimates by those charged with governance. This may include adequate supervision and review of the accounting estimates within the entity designed to detect and correct any deficiencies in the operating effectiveness of controls over the accounting estimates and its valuation.

A38H. The review and approval of accounting estimates by those charged with governance may particularly be important for accounting estimates that:

- Have a high estimation uncertainty;

- Are complex to make, for example, because of the extensive use of information technology, high volume of data and/or the use of multiple inputs with complex-interrelationships; or
- Have a change in the method or model compared to prior year.

The Entity's Information Systems

A38I.—The key objective of an entity's information system is that it is capable of capturing and recording all the transactions accurately, settling them, valuing them, and producing management information to support the effect operation of ~~for controls to be monitored~~. Difficulties can arise in entities that engage in a high volume of financial instruments, in particular if there is a multiplicity of systems that are poorly integrated and have manual interfaces without adequate controls.

A38J.—The development of certain accounting estimates, such as those involving the use of an expected credit loss model, may require a large volume of data and therefore sophisticated information systems. The sophistication of the information system depends on the nature of the accounting estimate and the entity's business processes. Specific issues which can arise with respect to accounting estimates that require a large volume of data or require the extensive use of information technology include:

- Information systems, in particular for smaller entities, not having the capability or not being appropriately configured to process large volumes of data. This may result in an increased number of manual transactions, which may further increase the risk of error;
- The potential diversity of systems required to process more complex transactions, and the need for regular reconciliations between them, in particular when the systems are not interfaced or may be subject to manual intervention;
- A lack of review of systems exception logs, to validate the entries generated by the systems;
- Failure to evaluate the design and calibration of complex models used to process the transactions initially and on a periodic basis;
- The potential that management has not set up a library of models, with controls around access, change and maintenance of individual models, in order to maintain a strong audit trail of the accredited versions of models and in order to prevent unauthorized access or amendments to those models; and
- The potential requirement for third-party systems provision, for example from a service organization, to appropriately record, process, account for or risk manage data transactions, and the need for management to reconcile appropriately and challenge the output from those providers.

A38K. Information systems relevant to financial reporting serve as an important source of information for the quantitative disclosures in the financial statements. However, entities may also develop and maintain non-financial systems used for internal reporting and to generate information included in qualitative disclosures, for example regarding risks and uncertainties or sensitivity analyses.

The Control Activities Relevant to Making the Accounting Estimates (Ref: Para. 8(e))

Relevant Controls (Ref: Para. 8(e)(ii))

A27. Matters that the auditor may consider in obtaining an understanding of the control activities relevant to making the accounting estimates relevant controls include, for example, the experience and competence of those who make the accounting estimates, and controls related to:

- The experience and competence of those who make the accounting estimates.
- How management determines the completeness, relevance and accuracy of the data used to develop accounting estimates. the accounting estimates, including when management uses a third-party data source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or inputs used in their development, by appropriate levels of management and, where appropriate, those charged with governance. This may also include assessing the adequacy of supervision and review of the accounting estimates within the entity, which is designed to detect and correct any deficiencies in the operating effectiveness of controls over the accounting estimates and its valuation.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services (for example, in the case of a large financial institution, relevant segregation of duties may include an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).

A28. ~~Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if~~ the entity uses specific models a model, whether it be management's own model or a third-party model, for making an accounting estimates estimate, including any sub-models that are relevant to the audit, management may put into place specific policies and procedures around such models. ~~Relevant controls may include, for example~~ This is especially relevant when the model to make the accounting estimate is considered to be complex, such as, those established over: an expected credit loss model. The complexity of a model depends on factors such as the (extensive) use of sub-models, the complexity of the formulas and interrelationships that may require specific knowledge. Depending on the nature of the model and the accounting estimate, factors that may be considered in obtaining an understanding of the model used to make the accounting estimate include the following:

- The design and development, or selection, of a particular model for a particular purpose.
- The use of the model How management determines the completeness, relevance and accuracy of the model used to develop accounting estimates:-
- Whether the model:-
- The maintenance and periodic is validated prior to usage, with regular reviews to ensure it is still suitable for its intended use. The entity's validation of the process may include evaluation of:
 - The method's theoretical soundness and the model's mathematical integrity; and,
 - The consistency and completeness of the model's inputs, and whether the appropriate data is used in the model and appropriate assumptions have been made.

- Whether there are appropriate change control policies over the model;
- The model is appropriately changed or adjusted on a timely basis for changes in (market) conditions;
- The model maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs;
- Whether adjustments made to the output of the model; and
- Whether the model is adequately documented, including the model's intended applications and limitations and its key parameters, required data, results of any validation analysis performed and any adjustments made to the output of the model.

The Entity's Activities to Monitor Controls over How the Accounting Estimates Are Made. (Ref: Para 8(f))

A38K. In many large entities, the internal audit function may perform work that enables management and those charged with governance to review and evaluate the entity's controls relating to significant accounting estimates. The internal audit function may assist in identifying the risks of material misstatement due to fraud or error. The extent to which the internal audit function has the knowledge and skill to cover, and has in fact covered, the entity's activities with respect to accounting estimates that are complex to make, as well as the competence and objectivity of the internal audit function, is a relevant consideration in the external auditor's determination of whether the internal audit function is likely to be relevant to the overall audit strategy and audit plan.

A38L. Areas where the work of the internal audit function may be particularly relevant are:

- Developing a general overview of the extent of use of accounting estimates and the nature of the accounting estimates;
- Evaluating the operating effectiveness of control activities over the data and models used to make the accounting estimate;
- Evaluating systems that generate the data on which the accounting estimate is based; and
- Assessing whether new risks relating to accounting estimates are identified, assessed and managed.

Matter for IAASB Consideration

5. The IAASB is asked for its views on the changes made to paragraph 8 and the related application material and specifically whether:
 - The changes related to paragraph 8(d), (e) and (f) are sufficiently granular to address the issues identified by the Task Force with respect to the control environment over making accounting estimates;
 - The changes related to models and data are sufficiently granular to address the issues identified by the Task Force; and
 - There are other areas where further requirements or guidance would be useful.

Retrospective Review

51. ISA 540 describes in paragraph 9 the retrospective review. 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. The objective of this review is to:
- a) 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;
 - b) Obtain audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates;
 - c) Obtain audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements; and
 - d) Identify circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias.
52. Discussion in the Task Force indicated that there are a variety of views on how and when to perform the retrospective review. The Task Force therefore discussed ways how to make this clearer in the requirements and the application material. Based on its deliberations, the Task Force was of the view that:
- a) The words "where applicable" should be moved to the start of the sentence, as currently it suggests that the accounting estimates should have an observable outcome (e.g., an accrual for travel expenses) or re-estimation for inclusion purpose of in the current period financial statements (e.g., a legal reserve for a specific claim). The Task Force noted that there is a third category: accounting estimates that do not have an observable outcome and are not re-estimated for inclusion in the current period financial statements, for example, fair value accounting estimates. For fair value accounting estimates, there is no observable outcome as the fair value determined at reporting date will never be observed as it is a point estimate. In these cases, a retrospective review could be less useful but (depending on the facts and circumstances) it could still provide the auditor with valuable information related to the risk assessment for accounting estimates.
 - b) 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.
 - c) 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 ISA 540. It was noted that in certain circumstances, small, individual changes to assumptions that are not significant year over year become significant when aggregated over several years. The Task Force included paragraph A42a to acknowledge this view.
 - d) 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.

9. When applicable, ~~t~~The auditor shall 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 financial statements. The nature and extent of the auditor's review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call into question the judgments made in the prior periods that were based on information available at the time. (Ref: Para. A39–A44)

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

- A39. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the prior period financial statements. For some accounting estimates with a high estimation uncertainty, the difference may be significant because of the nature of the accounting estimate. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may 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.
 - Audit evidence that is pertinent to the re-estimation, in the current period, of prior period accounting estimates.
 - Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
- A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.
- A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by ISA 240.¹⁷ That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls. As a practical matter, the auditor's review of prior period accounting estimates as a risk assessment procedure in accordance with this ISA may be carried out in conjunction with the review required by ISA 240.
- A42. The auditor may judge that a more detailed review is required for those accounting estimates that were identified during the prior period audit as having high estimation uncertainty, or for those accounting estimates that have changed significantly from the prior period. As part of the detailed review, the auditor may perform a retrospective review over the assumptions to which the accounting estimate is sensitive. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the

¹⁷ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A42A. In addition to the retrospective review over the prior period, the auditor may determine that a retrospective review over several periods or a shorter period (such as half-yearly or quarterly) period is useful. For example, for certain accounting estimates, individually small changes to the assumptions that are not significant year-over-year become significant when aggregated over several years. Where entities make accounting estimates that are realized within a shorter timescale than full financial reporting periods, considering the outcomes of such accounting estimates can also provide important information about management's current competencies and other factors relevant to making estimates. Considering outcomes of accounting estimates that are realized between the end of the financial reporting period and the start of the audit may be useful for similar reasons.

A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date, more variation may exist between the fair value amount recognized in the prior period financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a prior period fair value accounting estimate may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of prior period fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.

A44. A difference between the outcome of an accounting estimate and the amount recognized in the prior period financial statements does not necessarily represent a misstatement of the prior period financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the prior period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Matter for IAASB Consideration

6. The IAASB is asked for its views on the changes made to paragraph 9 and the related application material.

Identification and Assessment of the Risk of Material Misstatement

53. 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 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 Board in March 2016.

54. Although the Board generally supported this approach, discussions within the Task Force highlighted that including all elements could be overly burdensome for less complex accounting estimates. The Task Force also noted that additional factors would be needed, given that the factors that were elevated from paragraph A45 dealt with estimation uncertainty only and did not address the complexity in making the accounting estimate. The Task Force was therefore of the view that it would be useful to include some overarching factors and to keep more detailed factors in the application material and subsequently had a brainstorming session to determine these overarching factors.
55. In the brainstorming session, the Task Force determined, based on accounting estimates commonly included in the financial statements, which commonalities are present in making accounting estimates. For each factor identified the Task Force determined how high the risk of material misstatement would generally be with respect to the complexity in making the accounting estimate and estimation uncertainty. The factors that generally would have a high risk of material misstatement are included in the list below:
 - a) The extent to which the accounting estimate depends on subjective judgment, including assumptions;
 - b) The extent to which the accounting estimate is subject to high estimation uncertainty;
 - c) Whether the accounting estimate is based on data, from internal or external sources, that is unobservable, from outside the general and subsidiary ledgers, or difficult to obtain or complex;
 - d) The complexity in making the accounting estimate, including the extent to which the method used to calculate an accounting estimate uses complex modelling or uses large volumes of data;
 - e) Whether the accounting estimate is based on complex legal or contractual terms; and
 - f) The sensitivity of the accounting estimate to changes in data or assumptions.

Identification of Significant Risk

56. In discussing paragraph 10 and 11 of 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 risk of material misstatement related to an accounting estimate and the determination whether an accounting estimate would give rise to significant risk are similar.
57. Given the similarity of the factors considered in both the identification and assessment of the risk of material misstatement and the determination of whether an accounting estimate gives rise to a significant risk, most of the members of the Task Force were in favor of merging the requirements in paragraphs 10–11. It was further noted that including two distinct steps could lead to duplication in the application material and that combining these steps would be in line with practice.
58. Other Task Force members were of the view, however, that having two distinct steps would help the auditor navigate through the risk assessment for accounting estimates and that the steps that the auditors would have to go through are more aligned with ISA 315 (Revised). Given the different views both options are presented as below.

Option 1: Combining Requirement 10 and 11

Identifying and Assessing the Risks of Material Misstatement

10. In ~~identifying~~ applying ISA 315 (Revised), the auditor shall ~~identify~~ and ~~assessing~~ assess the risks of material misstatement, ~~as required by ISA 315 (Revised),¹⁸ the auditor shall evaluate the degree of estimation uncertainty associated with an, whether due to fraud or error, related to accounting estimates at the financial statement and assertion level, including determining whether any of the risks identified are, in the auditor's judgment, significant risks. In doing so, the auditor shall consider factors that may give rise to a risk of material misstatement, which includes, at a minimum, determining whether a risk of material misstatement exists resulting from one or more of the following factors: (Ref: Para. A465–A46B, A48, A50, A51)~~
- ~~(a) The extent to which the accounting estimates depend on subjective judgment, including assumptions; (Ref: Para. A47A–A47B)~~
 - ~~(b) The extent to which the accounting estimates are subject to high estimation uncertainty; (Ref: Para. A45, A47, A49)~~
 - ~~(c) Whether the accounting estimates are based on data, from internal or external sources, that is unobservable, from outside the general and subsidiary ledgers, difficult to obtain or complex; (Ref: Para. A51A)~~
 - ~~(d) The complexity in making the accounting estimates, including the extent to which the method used to calculate an accounting estimate uses complex modelling or uses large volumes of data (Ref: Para. A51B);~~
 - ~~(e) Whether the accounting estimates are based on complex legal or contractual terms; or~~
 - ~~(f) The sensitivity of the accounting estimates to changes in particular data and assumptions. (Ref: Para. A51C–A51D)~~

Option 2: Keep Requirement 10 and 11 Separate

Identifying and Assessing the Risks of Material Misstatement

10. In ~~identifying~~ applying ISA 315 (Revised), the auditor shall ~~identify~~ and ~~assessing~~ assess the risks of material misstatement, ~~as required by ISA 315 (Revised),¹⁹ the auditor shall evaluate the degree of estimation uncertainty associated with an, whether due to fraud or error, related to accounting estimates at the financial statement and assertion level. In doing so, the auditor shall consider factors that may give rise to a risk of material misstatement, which includes, at a minimum, determining whether a risk of material misstatement exists resulting from each of the following factors: (Ref: Para. A465–A46B, A48, A50, A51)~~
- ~~(a) The extent to which the accounting estimated depend on subjective judgment, including assumptions; (Ref: Para. A47A–A47B)~~
 - ~~(b) The extent to which the accounting estimates are subject to high estimation uncertainty;~~

¹⁸ — ~~ISA 315 (Revised), paragraph 25~~

¹⁹ — ~~ISA 315 (Revised), paragraph 25~~

(Ref: Para. A45, A47, A49)

(c) Whether the accounting estimates are based on data, from internal or external sources, that is unobservable, from outside the general and subsidiary ledgers, difficult to obtain or complex; (Ref: Para. A51A)

(d) The complexity in making the accounting estimates, including the extent to which the method used to calculate an accounting estimate uses complex modelling or uses large volumes of data (Ref: Para. A51B);

(e) Whether the accounting estimates are based on complex legal or contractual terms; or

(f) The sensitivity of the accounting estimates to changes in particular data and assumptions. (Ref: Para. A51C–A51D)

11. ~~The~~As part of the auditor's assessment of the risks of material misstatement in applying ISA 315 (Revised)²⁰, the auditor shall determine whether, ~~in the auditor's judgment taking into consideration the factors described in paragraph 10 at a minimum, any of these~~the identified risks relating to an accounting estimates ~~that have been identified as having high estimation uncertainty~~estimate give rise to one or more significant risks. (Ref: Para. ~~A47A46a~~A51)

Application Material to Paragraph 10 and 11

59. The application material to a combined paragraph 10 and 11 could look as follows. Further changes may be needed once the Board has decided on which option is preferred:

Identifying and Assessing the Risks of Material Misstatement

A46. ~~Other m~~Matters that the auditor considers in assessing the risks of material misstatement and the determination of whether an accounting estimate gives rise to a significant risk may also include:

- The actual or expected magnitude of an accounting estimate.
- The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.
- Whether management has used an expert in making the accounting estimate.
- The outcome of the review of prior period accounting estimates.

A46A. Some accounting estimates may have a high estimation uncertainty or are complex. For example, expected credit loss models are often complex because they require a highly specialized entity-developed model and involve high estimation uncertainty given the nature of the judgment. Other accounting estimates may only be complex to make or only have a high estimation uncertainty. For example, an obsolescence provision for inventory with a wide array of different inventory types and inputs may have low estimation uncertainty but requires complex systems, processes and judgments. Equally, other accounting estimates may not be complex but may have high estimation uncertainty that requires a single critical judgment, for example a single, clearly identifiable, level 3 financial instrument or a legal contingency.

²⁰ ISA 315 (Revised), paragraph 28

Significant Risks

A46B. Paragraph 28 of ISA 315 (Revised) and the related application material include general principles when identifying significant risks which are relevant when determining which accounting estimates give rise to significant risks.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A50. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.²¹

A51. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570²² establishes requirements and provides guidance in such circumstances.

Subjective Judgment (Ref: Para. 10(b))

A47A. The degree of subjective judgment associated with an accounting estimate may be influenced by several factors such as the length of the forecast period, whether there is comparable information available and how sensitive the accounting estimate is to particular data and assumptions. When there is a high degree of subjective judgment, the accounting estimate may be susceptible to management bias.

A47B. Examples of accounting estimates that may have a high degree of subjective judgment include the following:

- Accounting estimates that are based on future cash flows.
- Accounting estimates for litigation and claims where no case evidence is available.
- Accounting estimates with a long forecast period.

Estimation Uncertainty (Ref: Para. 10(b))

A45. The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

- The extent to which the accounting estimate depends on judgment.
- The sensitivity of the accounting estimate to changes in data and assumptions.
- The existence of recognized measurement techniques that may mitigate the estimation uncertainty (though the subjectivity of the assumptions used as inputs may nevertheless give rise to estimation uncertainty).
- The length of the forecast period, and the relevance of data drawn from past events to forecast future events.

²¹ ISA 315 (Revised), paragraph 29

²² ISA 570 (Revised), *Going Concern*

• ~~The availability of reliable data from external sources.~~

- The extent to which the accounting estimate is based on observable or unobservable inputs.
- ~~Whether using an alternative model could have resulted in a materially different amount due to the use of, for example, different data, or assumptions.~~

_____ The degree of estimation uncertainty associated with an accounting estimate may influence the estimate's susceptibility to management bias.

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are highly dependent upon judgment, for example, judgments about the outcome of pending litigation or the amount and timing of future cash flows dependent on uncertain events many years in the future.
- Accounting estimates that are not calculated using recognized measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.
- Fair value accounting estimates for which a highly specialized entity-developed model is used or for which there are no observable inputs.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

The Data on Which the Accounting Estimates Are Based (Ref: Para. 10(c))

A51A. The availability of relevant and reliable data in making an accounting estimate varies. Factors that may affect the risks of material misstatement include:

- Observability of the data. Some financial reporting frameworks establish a fair value hierarchy to develop increased consistency and comparability in fair value measurements and related disclosures, and data may be categorized according to the degree of observability. The nature and reliability of information available to support the data used to make the accounting estimate varies depending on the observability of inputs to its measurement. For example, the observability for a quote that is based on quoted prices (unadjusted) in an active market is high. On the other hand, when a quote is based on unobservable inputs, -as there are no observable inputs available-, the observability is low. In general, the reliability of the data decreases when the data is less observable.
- Data from outside the general and subsidiary ledgers, including data from external sources. For data from outside the general and subsidiary ledgers, it might be difficult to determine how the data was prepared and whether there were appropriate controls and governance

over that data;

- Data that is difficult to obtain. For example, some data may be difficult to obtain because it is purchased from a third party. Third-party data sources often do not allow the auditor access to the systems, processes and algorithms used because of confidentiality and or proprietary reasons.
- The complexity of the data. Data may, for practical or conceptual reasons, be aggregated, compressed or transformed. Depending on the nature and number of modifications the data has to go through, it may be more difficult for the auditor to determine whether the data is reliable; or
- The reliance on information technology. Data that is used to make the accounting estimate may be based on complex system-generated data that requires the involvement of information technology specialists.

Such factors may increase the risk of a material misstatement as they may indicate a need for specialized knowledge or skills to be involved in the audit, or it may be harder to obtain sufficient and appropriate audit evidence to support the accounting estimate.

The Complexity in Making the Accounting Estimates (Ref: Para. 10(d))

High Estimation Uncertainty and Significant Risks (Ref: Para. 11)

A51B. The degree of complexity involved in making an accounting estimate varies and come from various sources such as:

- The method used in making the accounting estimate. Some models are complex and may include formulas and interrelationships that require specific knowledge. Also, some financial reporting frameworks may require the use of certain complex methods.
- The volume and sources of data. To make certain accounting estimates, large volumes of data or data from multiple sources are required. In such circumstances, the entity might need to have an extensive internal control environment, sometimes in combination with extensive use of complex information technology.
- The complexity of the business processes to develop the accounting estimates.

Such factors may increase the risk of a material misstatement or give rise to a significant risk. In addition, they may require specialized knowledge or skills or it may be harder to obtain sufficient and appropriate audit evidence.

The Sensitivity of the Accounting Estimate to Changes in Particular Data and Assumptions (Ref: Para 10(f))

A51C. As described in paragraph A38A, some accounting estimates may be particularly sensitive to certain data and assumptions. When an accounting estimate is sensitive to changes in particular data and assumptions, the auditor may focus audit procedures on those data and assumptions that give rise to a risks of material misstatement. It may also enable the auditor to better apply professional skepticism in the most relevant circumstances .

A51D. A skeptical mindset is specifically important when an accounting estimate is sensitive to particular data and assumptions, as this sensitivity influences the degree of estimation uncertainty

associated with an accounting estimate, which in its turn may influence the accounting estimate's susceptibility to management bias. In these circumstances the auditor may, for example, compare its own analysis with management's, including an understanding of any differences between them.

Matters for IAASB Consideration

7. The IAASB is asked for its views on paragraph 10 and related application material and specifically whether:
 - Paragraph 10 and 11 should be combined or separated;
 - The granularity of the factors included in paragraph 10 is on the right level; and
 - There are any factors are missing or whether any factors included should be deleted.
8. The IAASB is asked whether it agrees with the Task Force's approach of applying the concept of the sensitivity of the accounting estimates to factual or judgmental misstatements in using data and assumptions. This approach is demonstrated in requirements relating to the risk assessment (paragraph 8(c)(vi)) and the identification of and assessment of the risk of material misstatement (paragraph 10(f)).

Section B-4: Response to Identified Risks of Material Misstatement

60. The Task Force believes that the focus on the risk assessment requirements, and the IAASB's input thereon, will enable the Task Force to make better progress on the work effort requirements over Q3. The Task Force has only had preliminary discussions about the work effort required in response to the identified risks of material misstatement, but notes that explaining some of its current thinking and considerations will enable the IAASB to provide early, strategic-level input.
61. The paragraphs below include some preliminary drafting that has been prepared for the Task Force's input and discussion in light of the direction that the Task Force wishes to explore. While the Task Force is always open to receiving drafting comments from the IAASB, the Task Force is sharing this drafting to enable the IAASB to understand and contextualize the direction discussed in the paragraphs below. The drafting shown below is in clean (unmarked) text – the Appendix contains the equivalent paragraphs from extant ISA 540.

Events Occurring after the Date of the Financial Statements

62. The Task Force discussed how to deal with accounting estimates that, while they may have had some level of estimation uncertainty when management was preparing the financial statements, do not have any estimation uncertainty at the date of the auditor's report as the asset has been realized or liability settled. This situation may occur with certain types of assets and liabilities such as contingent liabilities and debts. In dealing with these items, the auditor may be able to verify that the uncertainty has been resolved by looking at events occurring after the financial statements have been prepared, and this may be highly likely to result in sufficient appropriate audit evidence (SAAE) about the accounting estimate. Therefore, the Task Force has discussed whether there should be a step in the work effort that requires the auditor to consider whether looking at post-balance date events is likely to yield SAAE – and no further procedures would then be required (except with reference to disclosures). The Task Force has also discussed whether this procedure should be conditionally

mandatory for such circumstances (as it may be the best source of evidence) or whether the auditor should be allowed to decide whether to perform the procedure.

63. The following is an example of how such a paragraph could be drafted:

If the nature of the accounting estimate is such that events occurring up to the date of the auditor's report may provide SAAE the auditor [shall/shall consider whether to] obtain such audit evidence. (Ref: Para. A62–A67)

Matter for IAASB Consideration

9. The IAASB is asked for its views on the discussion on the treatment of events occurring after the date of the financial statements as discussed above.

A Principles-Based Work Effort Requirement

64. One option the Task Force has discussed is to have an overall umbrella requirement under which the more detailed work effort requirements would fit. Under this approach, the auditor would have an obligation to meet the principles-based requirement, which would be done by developing one or more detailed procedures responsive to the specific circumstances. However, if those more detailed procedures were not enough to obtain SAAE, the auditor would have to continue performing procedures.

65. If such an approach could be developed, it might aid in responding to the calls made by some at the recent CAG meeting for a more principles-based approach and may cater better for accounting estimates with a range of complexity and estimation uncertainty by requiring the auditor to make a judgment about what needs to be done for the specific accounting estimate. On the other hand, the flexibility for the auditor in this approach, if not backed up by work effort requirements that are mandatory at least in certain conditions, may not meet the calls from some stakeholders for a more detailed and prescriptive work effort.

66. The following is an example of how such a paragraph could be drafted:

In responding to the assessed risks of material misstatement, as required by ISA 330,²³ the auditor shall design and perform procedures responsive to the risks of material misstatement identified and assessed in accordance with paragraph 10.

Matter for IAASB Consideration

10. The IAASB is asked for its views on the utility of an overarching principles-based work effort requirement.

Detailed Procedures Linked to the Risk Assessment

67. The Task Force has noted that the added detail on the factors that the auditor has to take into account in identifying and assessing the risks of material misstatement (see draft paragraph 10 in Section B-3 above) may permit the work effort to include more specific requirements for each of those factors. The Task Force's discussions have noted the following challenges:

²³ ISA 330, The Auditor's Responses to Assessed Risks

- (a) On one hand, it may be useful to prescribe particular procedures as responses to particular risks. For example, if the auditor has identified that the need for subjective judgments is a factor that results in a risk of material misstatement, the work effort requirements could mandate that the auditor must evaluate whether management's judgments are reasonable in light of the financial reporting framework. This might be viewed as better aligning the required work effort with the identified and assessed risk, and could be seen as helpful to ensure that appropriate procedures are performed in response to the identified risks of material misstatement resulting from the factors identified in draft paragraph 10 in Section B-3. If such an approach could be developed, based on strengthened principles within the ISA, it might go some way in meeting the calls from some stakeholders for a more detailed and prescriptive work effort.
 - (b) On the other hand, this approach may be seen as overly prescriptive by those (including some at the CAG) advocating for a more principles-based approach, in that it restricts the ability of the auditor to choose an alternative procedure (which may include procedures the auditor considers to be more effective or efficient). By way of explanation, in the example given in the preceding paragraph, the auditor could choose to develop their own point estimate (perhaps because they lack confidence in management's process and therefore expect to be unable to obtain SAAE, or because the auditor has expertise in the development of point estimates and sees it as a more efficient way of obtaining SAAE).
68. The following is an example of mandatory procedure linked to a specific condition. The Task Force has noted that additional application material explaining different approaches to testing a model would be of benefit:

When management uses a model, evaluate whether testing the model and the data and assumptions to which the accounting estimate is particularly sensitive is appropriate to respond to the assessed risks. If such testing is appropriate, the auditor shall do so, including critically evaluating whether, in respect of the data and assumptions that most influence estimation uncertainty in the method used and that have the greatest impact on the accounting estimate: (Ref: Para. A68–A70)

- (a) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework; and (Ref: Para. A77–A83)]
- (b) The data used by management is accurate, complete, and appropriate for the model.

Task Force Discussions on Extant ISA Work Effort Requirements for “Normal” Risks

69. The Task Force has continued to discuss the amendments that may be required to paragraphs 12–14 of ISA 540, and particularly their relationship with the more detailed risk assessment as described in Section B-3. The Task Force has also agreed that significant effort over the coming months needs to be put into considering the appropriate work effort in relation to models (including whether separate requirements can be developed for complex models) and the implications for the entity's use of third-party data sources or experts in making the accounting estimate.

Matter for IAASB Consideration

11. The IAASB is asked for its views on the the Task Force's proposals related to strengthening the work effort as described above

Task Force Discussion on Extant ISA Work Effort Requirements Regarding Significant Risks

70. The Task Force is continuing to discuss possible changes to the work effort for significant risks (paragraphs 15–17 of ISA 540). Based on the discussions to date, the Task Force has tentatively agreed to investigate combining some elements of the extant ISA 540 work effort on significant risks (specifically, the requirement in paragraph 17 to obtain SAAE regarding recognition of accounting estimates in the financial statements) with that applicable to “normal” risks, as it was difficult for some of the Task Force to understand why the same work effort would not apply to all accounting estimates with a risk of material misstatement (although there continues to be diversity of views in this regard).

Matter for IAASB Consideration

12. The IAASB is asked for its views on approaches or procedures that the Task Force could investigate relating to accounting estimates that give rise to significant risks.

Standback requirement

71. Given the wide range of accounting estimates, with varying levels of estimation uncertainty and complexity, most of the Task Force sees merit in having a standback requirement for accounting estimates with high levels of estimation uncertainty or complexity. This would mean that the auditor would need to consider whether they have obtained SAAE, taking into account both evidence that corroborates management's accounting estimate and evidence that contradicts it. The Task Force notes that such a procedure may be particularly relevant when dealing with the accounting estimates with the highest estimation uncertainty and complexity as it will force an overall assessment of the audit evidence obtained on the accounting estimates that are likely to involve the greatest amount of professional judgment.
72. The following is an example of how such a paragraph could be drafted:

[For accounting estimates with high estimation uncertainty or that exhibit high levels of complexity],²⁴ the auditor shall conclude whether sufficient appropriate audit evidence has been obtained regarding the assessed risks of material misstatement of the accounting estimates, taking into account all relevant audit evidence, whether corroborative or contradictory. If the auditor has not obtained sufficient appropriate audit evidence, the auditor shall attempt to obtain further audit evidence by performing additional procedures from paragraph 13B or other procedures that are responsive to the relevant risks of material misstatement. (Ref: Para A109a)

²⁴ The Task Force has included this condition to trigger the requirement to enable the IAASB to understand the direction being considered. As with other drafting being explored in Section B-4, the drafting is not final.

Matters for IAASB Consideration

13. The IAASB is asked for its views on the possible standback requirement described above.
14. Members are asked to share their views on whether there are matters not discussed above that should be considered for inclusion in the work effort requirements.

Extract From Extant ISA 540

The following paragraphs are from extant ISA 540 and are included for reference purposes.

Responses to the Assessed Risks of Material Misstatement

12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)
 - (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53–A56)
 - (b) Whether the methods for making the accounting estimates 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. (Ref: Para. A57–A58)
13. In responding to the assessed risks of material misstatement, as required by ISA 330,²⁵ the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59–A61)
 - (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)
 - (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor shall evaluate 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 over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84–A86)
 - (d) Develop a point estimate or a range 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

²⁵ 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)

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 330,²⁶ 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)
 - (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)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:
- (a) Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (Ref: Para. A113–A114)
 - (b) The selected measurement basis for the accounting estimates, (Ref: Para. A115) are in accordance with the requirements of the applicable financial reporting framework.

²⁶ ISA 330, paragraph 18