

**ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures –  
Issues and Task Force’s Recommendations****Introduction**

1. This paper is organized as follows:
  - Section I: Introduction, objective, and risk assessment procedures;
  - Section II: Work effort;
  - Section III: Other matters; and
  - Section IV: Conforming Amendments.

**Section I – Introduction, Objective, and Risk Assessment Procedures**

2. The Task Force has proposed changes to the draft proposed International Standard on Auditing (ISA) to make the concepts underlying the standard clearer and more easily applied in practice. This included reinforcing the material describing the relevant factors that the auditor should take into account when identifying and assessing the risks of material misstatement, which are:
  - Complexity in making the accounting estimate;
  - The need for the use of judgment by management; and
  - Estimation uncertainty.
3. These factors play a central role in the revised version of ISA 540. Accordingly, ISA 540 focuses the auditor’s attention on designing and performing further audit procedures (including, where appropriate, tests of controls) responsive to the reasons for the assessment given to the assessed risks of material misstatement, particularly when those reasons include complexity, judgment or estimation uncertainty.
4. The factors of complexity, judgment or estimation uncertainty are highlighted in the Introduction section, and Appendix 2 provides additional background information on these factors. Based on the understanding of the entity and its environment obtained by the auditor in accordance with paragraph 8, paragraph 10 requires the auditor to take the factors listed above, and any other relevant factors, into account in the identification and assessment of the risks of material misstatement related to an accounting estimate. Section II describes the auditor’s response to the risks of material misstatement.

**Introduction to the ISA**

5. As mentioned above, the Introduction has been enhanced to set the context for readers of the ISA by explaining important concepts that are needed to correctly interpret the ISA. To supplement these explanations, appendices have been drafted to explain the different types of measurement basis and how they affect making accounting estimates (Appendix 1 of Agenda Item D-2), and the differences and relationship between the factors (Appendix 2 of Agenda Item D-2).
6. The Introduction section also outlines some matters that are important in auditing accounting estimates. For example paragraph 3C highlights the importance of professional skepticism in auditing accounting estimates and notes that there is an increased risk of management bias related to

accounting estimates. Paragraph 4 explains that reasonableness involves considerations beyond whether the accounting estimate and related disclosures comply with the requirements of the applicable financial reporting framework.

7. Each of the relevant factors are described in the introduction and Appendix 2. In brief, the relevant factors are:
  - Complexity in making accounting estimates can arise from different sources and specialized skills or knowledge may therefore be needed. Complexity may come from:
    - Selecting, designing or applying the method used to make the accounting estimate, including when the method involves complex modelling;
    - Understanding the relevance and reliability of the data used, regardless of whether the data is obtained from internal sources or from external information sources; or
    - Maintaining the integrity of the data used.
  - The need for the use of judgment by management – When an accounting estimate is required, the applicable financial reporting framework may not fully specify, for each type of financial statement item and in each possible circumstance, the most appropriate approach to make that accounting estimate. In general, the applicable financial reporting framework will specify the objective of the measurement. It is also generally not practical for the applicable financial reporting framework to specify all the particular valuation attributes, concepts and techniques that should be used to determine the accounting estimate and related disclosures. As a result, these considerations generally establish a need for the use of judgment by management in making accounting estimate.
  - Estimation Uncertainty – This is the inherent uncertainty that makes accounting estimates susceptible to a lack of precision in the measurement. It arises when a monetary amount for a financial statement item cannot be obtained by direct observation before the financial statements are finalized. An example could be an allowance for doubtful accounts for a portfolio of several trade debtors. To determine the provision there is inherent uncertainty whether or not the trade debtor will meet its obligations.

### **Objective**

8. The Task Force is proposing a change to the objective of ISA 540. In extant ISA 540, the auditor's objective in relation to disclosures uses the term "adequate", whereas for accounting estimates the term used is "reasonable" (see paragraph 6 of Agenda Item D-1). The Task Force was of the view that using a different adjective is confusing and may suggest that disclosures are somehow less important than the accounting estimate itself. Accordingly, the Task Force concluded that both the accounting estimate and the related disclosures should be reasonable in light of the applicable financial reporting framework.
9. Some Task Force members questioned whether the term 'reasonable' is a sufficiently high threshold. It was noted that given the subjective nature of the word reasonable, the use of the term "reasonable" may not adequately promote, and could undermine, the exercise of professional skepticism. The Task Force considered several alternative approaches at the November 2016 IAASB teleconference, however none were found to be appropriate as they were seen to imply a lower threshold than "reasonable." The Task Force therefore decided to explain what is meant by 'reasonable' in the 'key

concepts' section (paragraph 4 of Agenda Item D-2) and the application material (paragraph A1B and A1C of Agenda Item D-2) by providing criteria for "reasonable." This approach is similar to the approach taken in ISA 200<sup>1</sup> where the application material explains what is meant with reasonable assurance.

#### **Matters for IAASB Consultative Advisory Group (CAG) Consideration**

1. The IAASB CAG is asked for its views on:
  - (a) The introduction section, including the new appendices; and
  - (b) Whether the factors of estimation uncertainty, judgment and complexity are clear and understandable in light of their importance to the identification, assessment and response to risks of material misstatement.

#### **Risk Assessment**

10. To explain the Task Force's intention and to make the concepts underlying the standard more clearly, the Task Force made considerable changes to the risk assessment section of the ISA. The main changes are:
  - Adding a requirement (paragraph 8(c)(aA)), and related application material, that requires the auditor to obtain an understanding of the regulatory factors, including the regulatory environment, relevant to accounting estimates. The Task Force was of the view that adding this paragraph enhances the standard as obtaining an understanding of the regulatory factors may:
    - Assist the auditor in determining whether there are disclosures required in addition to the requirements of the applicable financial reporting framework; and
    - Provide the auditor with an indication of areas for which there may be a potential for management bias to meet regulatory requirements.
  - Adding a requirement for the auditor to obtain an understanding of how management identifies and addresses the risk of management bias (paragraph 8(c)(iiiA)). This supplements the requirement in paragraph 8(aB) that, before the auditor discusses the matter with management, the auditor shall independently consider the nature of the accounting estimates expected to be included in the financial statements.
11. The Task Force also expanded the application material related to paragraph 8. For example, application material was added to explain how inactive or illiquid markets may influence assumptions (paragraph A35B and A35C). The Task Force furthermore enhanced the application material related to the following requirements:
  - Obtaining an understanding of managements' method to make the accounting estimate (paragraph 8(c)(ii));
  - Obtaining an understanding of the data that management uses to make the accounting estimate (paragraph 8(c)(ii));

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<sup>1</sup> Paragraph 5 of ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

- Obtaining an understanding of the assumptions management uses to make the accounting estimate (paragraph 8(c)(ii)); and
  - The components of internal control as they relate to accounting estimates (paragraph 8(d)).
12. The Task Force acknowledged the broad support for the factors that may give rise to the risk of material misstatement (that is, complexity, judgment, and estimation uncertainty) but that further clarification would make the factors more capable of consistent application in practice. In light of this, the Task Force made changes to paragraph 10 and the associated application material (paragraphs A44F–A49C) to further explain these concepts and to show how they are to be applied in practice.

**Matter for IAASB CAG Consideration**

2. The IAASB CAG is asked for its views on the revisions to the risk assessment (paragraphs 8-10 of Agenda Item D-2).

**Section II – Work Effort**

13. The ISA 540 Task Force has taken into account comments from the IAASB and the CAG about improving the clarity and simplicity of the ISA's work effort, while continuing to seek improvements to aspects of the work effort, such as a renewed focus on highlighting when controls testing is needed. At the December 2016 IAASB meeting, the Task Force presented a revised approach to the work effort, which the IAASB generally supported.

**Overview of the Revised Work Effort**

14. The Task Force notes that the work effort in ISA 540 needs to be based on ISA 330<sup>2</sup> while emphasizing the characteristics that make accounting estimates different from other financial statement items.
15. Accordingly, paragraph 13:
- Draws a link with the general requirement in ISA 330.
  - Highlights when testing the operating effectiveness of controls is mandatory – that is, when the auditor intends to rely on those controls or when substantive procedures alone cannot provide sufficient appropriate audit evidence (SAAE). This is supported by application material (see paragraph A57A) that highlights common circumstances where the nature of the accounting estimates may preclude a purely substantive audit approach.
  - Builds upon the relevant factors by requiring the auditor to design and perform procedures that are responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10.
  - Recognizes that some accounting estimates are relatively “simple” and a more direct approach may be possible.
16. The revised work effort differentiates between the level of risk of material misstatement (ROMM), and whether that risk is due to inherent risk, control risk, or a combination. The table below explains how this is articulated in the ISA and the implications of each level of risk:

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<sup>2</sup> ISA 330, *The Auditor's Responses to assessed Risks*

Level of ROMM	Response	Explanation
<p>Low, but not because that assessment includes an expectation that relevant controls are operating effectively (see paragraph 13(a) of Agenda Item C-1)</p>	<p>Consider whether an overall procedure(s) would provide sufficient appropriate audit evidence (SAAE) – and then design and perform those procedures. For example, obtaining audit evidence about events occurring up to the date of the auditor’s report or performing a substantive analytical procedure.</p>	<p>These are generally risks related to simpler estimates (depreciation etc.) where ROMM is low, regardless of whether there are controls in place.</p>
<p>Low, and that assessment includes an expectation that relevant controls are operating effectively (see paragraph 13(b) of Agenda Item C-1)</p>	<p>Design and perform further audit procedures, which include tests of controls to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable.</p>	<p>This requirement is for risks where inherent risk is not low, but the auditor expects that relevant controls are operating effectively and therefore is able to assess ROMM as low. Accordingly, the auditor is required to test those controls, as well as perform other further audit procedures as necessary to obtain SAAE.</p>
<p>Not low (see paragraph 13(c) of Agenda Item C-1)</p>	<p>Design and perform further audit procedures (substantive or tests of controls) to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable</p>	<p>These risks are those where inherent risk is not low, regarding of whether there are relevant controls that operate effectively. Accordingly, the auditor needs to design and perform procedures to respond to the assessed risk – and has the flexibility to choose an audit approach (substantive procedures, tests of controls, or a combined approach) that suits the circumstances.</p>

**The Auditor’s Work Effort in Response to Complexity, Judgment, and Estimation Uncertainty**

- At the September 2016 IAASB CAG meeting, the CAG discussed the Task Force’s proposed work effort, which was based on the concept of a list of procedures in a table. The Task Force spent considerable time discussing how best to articulate the work effort in such a manner, and noted that any approach based on providing a list of procedures (which is also done in extant ISA 540, paragraph 13) would necessarily suffer from the same disadvantage – that the listing of procedures does not aid the auditor in selecting the most appropriate procedure. The Task Force’s view was that further investigation and exploration of alternatives was needed to determine whether an alternative approach could better articulate what the auditor needs to do in different circumstances.

18. The approach the Task Force settled on was discussed and generally supported at the IAASB's December 2016 meeting. The revised approach (as shown in paragraphs 13A–13C) is based on implementing the revised and enhanced risk assessment approach set up in paragraph 10 of the ISA. That is, the auditor's further audit procedures need to be responsive to the reasons given to the assessment of the ROMM – such as complexity, the use of judgment by management, or estimation uncertainty. Importantly, under this approach, procedures are not specified – rather the work effort is “objectives-based.” This means that paragraphs 13A–13C, generally, stipulate what outcome or objective the auditor needs to attain, but does not specify the procedures that the auditor must or can use. In this way, the auditor has flexibility to design an appropriate approach but has a clear objective.
19. For example, if the auditor identifies a ROMM that the significant assumptions in an accounting estimate may be incorrect (according to paragraph 10(b)), then the auditor would be required to comply with paragraph 13B that deals with the matters related to the use of judgment by management. The auditor would then refer to 13B(a) which applies “when the accounting estimate involves the use of significant data or assumptions” and would then design and perform audit procedures to address the matters in paragraph 13B(a)(i)-(iv). This would include obtaining audit evidence about whether management's judgments in relation to the significant assumptions are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework, whether there are indicators of management bias, whether changes from previous periods (if any) are appropriate, whether the assumptions are consistent with those used in other accounting estimates or other areas of the entity's business activities, and whether management's judgments in applying the applicable financial reporting framework are appropriate.
20. In some limited cases when dealing with estimation uncertainty, the Task Force has continued to specify procedures. The particular circumstances when this occurs is described in paragraph 13C(b) and (c), which is when, in the auditor's judgment, management has not appropriately addressed the effect of estimation uncertainty. In this circumstance, the only procedures that the auditor can do is develop a point estimate or range to evaluate management's point estimate and related disclosures that describe the estimation uncertainty. No other procedure would be effective as the auditor must be able to determine if management's point estimate is misstated, which requires the auditor to determine what would be a reasonable accounting estimate.

**Matter for IAASB CAG Consideration**

3. The IAASB CAG is asked for its views on the proposed work effort requirements in paragraphs 13–13C and associated application material.

## **Section III – Other Matters**

### **Disclosures**

21. Disclosures are a critical element of the auditor's work in relation to accounting estimates. Accordingly, the Task Force has looked to reinforce the auditor's work in relation to disclosures by amending the objective (see paragraph 6 of Agenda Item D-2) and by including disclosures explicitly in the auditor work related to estimation uncertainty (see paragraph 13C(a) and (b) of Agenda Item D-2). The Task Force has also enhanced the requirement addressing disclosures more generally to include requirements addressing, for fair presentation frameworks, whether additional disclosures

are required to achieve fair presentation and, for compliance frameworks, whether the disclosures are appropriate for the financial statements not to be misleading.

### **Stand Back**

22. The Task Force has developed an explicit stand back requirement for ISA 540, as was shared with the CAG in September. During various discussions with the IAASB and CAG, it was noted that there should be a clear link with the stand back requirement in ISA 330,<sup>3</sup> that is should include material on management bias, and it should be clear what accounting estimates are intended to be included.
23. The Task Force responded to these concerns by redrafting much of the stand back requirement (see paragraph 13E of Agenda Item D-2). The improvement included making the link with ISA 330 explicit, including new application material to explain the purpose of the requirement and to provide guidance on key aspects (see paragraphs A121AA–A121AC of Agenda Item D-2) and including material on the presence of indicators of management bias.
24. The Task Force also amended the requirement to make clear that paragraph 13E only applies to accounting estimates for which the auditor's performed procedures to address the matters in paragraphs 13A-13C (that is, when there were risks related to complexity, judgment, and estimation uncertainty). The Task Force noted that attempting to deal with all accounting estimates in a stand back provision would likely dilute the auditors focus on those estimates which the auditor had identified as being of higher risk.

### **Evaluating the Reasonableness of Accounting Estimates, and Determining Misstatements**

25. In previous versions of the stand back requirement, the Task Force had attempted to include extant paragraph 18, which addresses the evaluation of misstatements, in the stand back requirement. Upon reflection, the Task Force determined that this resulted in confusion over the purpose of the stand back, and so have separated the requirement again (see paragraph 13F of Agenda Item D-2).
26. The Task Force also noted that it was important that, in evaluating the misstatement (if any), the auditor should consider all relevant audit evidence obtained whether corroborative or contradictory. This is an important message that stakeholders have raised during the outreach conducted by the Task Force.

### **Other Changes**

27. In addition to the above changes, the Task Force has also proposed other changes to respond to matters raised during the outreach, discussions with the IAASB or CAG, or during the Task Force's own deliberations. In brief, these include:
  - (a) Management Bias (paragraph 21) – In addition to specific material addressing management bias in paragraphs 13A-13C and 13E, the Task Force has also clarified in paragraph 21 that when indicators of possible bias are identified, the auditor needs to evaluate the implications for the audit.
  - (b) Written Representations (paragraph 22) – The existing requirement on written representations has been supplemented by an additional requirement to consider whether representations are needed about specific accounting estimate (including with respect to the methods).

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<sup>3</sup> ISA 330, paragraphs 25–26

#### Matter for IAASB CAG Consideration

4. The IAASB CAG is asked for its views on the remainder of the draft proposed ISA. In particular, views are sought on whether the draft text is clear, understandable, and capable of practical application.

### Section IV – Consequential and Conforming Amendments

28. The Task Force made consequential and conforming amendments to ISA 260 (Revised),<sup>4</sup> ISA 500<sup>5</sup> and ISA 580.<sup>6</sup> While the changes to ISA 260 (Revised) and ISA 580 are limited to minor changes, the proposed consequential and conforming amendments to ISA 500 are more significant. These changes are included in **Agenda Item D.4**.
29. This is because, in the Project Proposal that began the project to revise ISA 540, the IAASB acknowledged that amendments to ISA 500 may be needed to clarify the distinction between a third-party pricing source and a management's expert, as defined in ISA 500. In addition, the IAASB noted that there may be merit in clarifying the related auditing considerations in light of the relevant material contained in International Auditing Practice Note 1000.

#### *External Information Sources*

30. In the September 2016 CAG Meeting the Task Force referred to 'external data source' instead of 'third-party pricing sources' as many entities use external parties for data other than prices, and the IAASB believed that a more holistic approach was warranted. In its deliberations the Task Force noted that ISA 500 generally uses the term 'information' in relation to audit evidence. Accordingly, the Task Force concluded that using the term 'external information sources' would be more appropriate. This is especially important as the term "information" is broader than "data" and ISA 500 is dealing with more than just data.

#### *The Difference between an External Information Source and a Management's Expert*

31. In crafting a definition of an external information source, the Task Force noted that in certain circumstances an individual or organization can be a management's expert or an external information source depending on the facts and circumstance. For example, a pricing service may provide prices on some commonly traded securities as an external information source, but may also offer expert valuation services for more exotic financial instruments. The Task Force was of the view that, with respect to the same information, the individual or organization can be either an external information source or a management expert's but not both. The Task Force recognized that this may be an area of confusion for practitioners and therefore added 'and is not a management's expert' in the definition of an external information source to make this clear.
32. The application material (Paragraph A1A-A1C) provides guidance about how an external information source can be distinguished from a management's expert by highlighting that:
  - The information is not specifically generated for the entity; and

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<sup>4</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>5</sup> ISA 500, *Audit Evidence*

<sup>6</sup> ISA 580, *Written Representations*



- The information is generally available to the public.

The application material also includes examples of external information sources and highlights that, depending on the facts and circumstances, an individual or organization may be an external information source or a management's expert.

*Audit Evidence Implications of Information from External Information Sources*

33. With respect to data from internal and external sources, the Task Force points out extant ISA 500 describes in paragraph 8 how to address information prepared using the work of a management's expert and describes in paragraph 9 how to address information prepared by the entity. Paragraph 7 is the overarching requirement.
34. The Task Force discussed in which requirement a reference to external information sources should be made, including whether a new requirement would be needed. Given the scheduled project on ISA 500, the Task Force was of the view that changes to ISA 500 should be limited and was therefore not in favor of creating a new requirement. After considering alternatives, the Task Force is of the view that paragraph 7 would be best given that it is the overarching requirement and it refers to both the relevance and reliability of the audit evidence. The application material highlights:
  - Factors that may be important to consider about the relevance and reliability of information obtained from an external information source (Paragraph A33B);
  - That the ability of the auditor to consider the reliability of the information from the external information source may vary significantly depending on the source (Paragraph A33C);
  - That the availability of information to understand the methods and assumptions used by the external information source may influence the auditor's ability to consider the nature, timing and extent of the auditor's procedures (Paragraph A33D);
  - That the observability of inputs and complexity of methods used to generate the information from the external information source may influence the nature and extent of procedures that the auditor needs to perform to test the reliability of information from an external information source (Paragraph A33E);
  - Possible approaches for the auditor to consider the relevance and reliability of information from external information source (Paragraph A33F);
  - For fair value measurements, additional considerations of the relevance and reliability of the information used (Paragraph A33G); and
  - That in some cases the auditor and management may use the same external information source and that in such circumstance consideration may need to be given to whether the information from the external information source is accurate and complete. (Paragraph A33H).

**Matter for IAASB CAG Consideration**

5. The IAASB CAG is asked for its views on the consequential amendments made to ISA 500, including whether the definition of an external information source is clear and understandable.