



For the attention of Mr Matt Waldron
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, New York, 10017
USA

[Submitted via IAASB website]

1 August 2017

Dear Mr. Waldron

**IAASB Exposure Draft: Proposed International Standard on Auditing 540 (Revised)
*Auditing Accounting Estimates and Related Disclosures***

We¹ appreciate the opportunity to comment on the IAASB's Exposure Draft (ED).

Accounting estimates and related disclosures ("accounting estimates") are an integral part of financial reporting, often having a significant impact on the results of operations and financial position presented in financial statements. The evolving business environment and related developments in financial reporting frameworks are resulting in increasing complexity and management judgement in making accounting estimates. We, therefore, support the IAASB in developing a revised ISA 540 that:

- incorporates relevant considerations underpinning how accounting estimates need to be made in the context of relevant financial reporting requirements; and
- supports the performance of high quality, scalable, auditing procedures over accounting estimates, including reinforcing professional scepticism and evaluating the sufficiency of the audit evidence obtained.

We applaud the extensive outreach undertaken by the IAASB with a wide variety of stakeholders in informing and developing the proposed changes. We support the aim of promoting a more granular consideration of "what could go wrong", to inform the auditor's risk assessment at the assertion level and design of appropriate responses. Much of the related guidance that has been added in the application material is very valuable.

We also believe that close alignment between the IAASB and PCAOB standards on auditing accounting estimates is in the public interest and in our recommendations we make reference to the recent exposure draft issued by the PCAOB².

Notwithstanding our overall support, we believe that key aspects of the ISA need to be reconsidered, in particular:

- The integration of proposed, contextual, risk factors into the risk assessment framework and, in particular, as the basis for designing the audit response is unduly complicated and risks

¹ This response is being filed on behalf of the network of member firms of PricewaterhouseCoopers International Limited and references to "PwC", "we" and "our" refer to the PwC network of member firms.

² PCAOB Release No. 2017-002, Auditing Accounting Estimates, Including Fair Value Measurements

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creating confusion and unnecessary challenges in practical application. It does not reflect how an experienced auditor thinks about auditing an accounting estimate.

- “Low inherent risk” as a threshold for driving the extent of the auditor’s work effort is not, in our view, an effective response to concerns about the scalability of the ISA. The three alternative “testing approaches” presented for low inherent risks apply to the response to any accounting estimate, not just those with low inherent risk. Furthermore, some of the “responses” for other than low inherent risks would be part of how the auditor can respond to a low inherent risk. Therefore, as our field testing showed, it is very unclear what the threshold actually achieves in practice.

In the remainder of this covering letter, we provide an overview of what we consider to be necessary changes to address the concerns described above. Our comments on how to address the points above reflect where we felt the structure of the PCAOB standard was more logical and capable of practical application, while still achieving the desired objectives.

Responses to the specific questions posed in the explanatory memorandum, including additional explanation of the matters addressed in this covering letter, together with constructive drafting suggestions that would address our comments, have been included in the accompanying appendices.

The proposed use of factors unduly complicates the auditor’s risk assessment

We believe that identifying and assessing the risks of material misstatement for account balances, classes of transactions, and disclosures at the assertion level remains appropriate. The assertions identified in ISA 315 (e.g., existence, completeness, accuracy, valuation) are the ways in which an account balance can be misstated. Complexity, judgment and estimation uncertainty are contextual factors that can influence the assessment of risk (e.g., whether a risk of misstatement at the assertion level is low, or higher, or a significant risk), as well as how best to design the approach to obtain audit evidence in response to identified risks. The factors are not, in and of themselves, “what could go wrong”.

For these reasons, we are concerned that:

- The way in which the proposed risk assessment requirement in paragraph 13 is drafted, in conjunction with the fact that the requirements in paragraphs 17-19 for the related response to assessed risks are driven by each factor, is leading to: i) a perception of the need to explicitly identify and assess risks by factor, even though complexity, judgement and estimation uncertainty are not mutually exclusive; and ii) confusion over which factors, individually or in combination, are “the reasons for the assessment given to the risk”, which is problematic as that determines the application of paragraphs 17-19.
- The proposed approach will require documentation of a complex matrix of the identification and assessment of each risk by: i) assertion (as required by ISA 315); and ii) then also by each of the three risk factors.
- There is also no clear linkage in paragraph 13 back to paragraph 10, which identifies the matters for which the auditor is required to obtain an understanding to inform the auditor’s risk assessment. There is therefore confusion about how to relate the risk factors in paragraph 13 to the understanding obtained in accordance with paragraph 10 in performing the risk assessment.

For all of these reasons, we believe that suggesting that the auditor make risk assessments by both assertion and factor will cause confusion and will not enhance the auditors’ risk assessment or audit response. This concern extends not only to ISA 540 but also to the proposed revision of ISA 315, where we note similar consideration is being given to the use of risk factors.

We strongly recommend that the proposed risk factors of complexity, the need for the use of judgement, and estimation uncertainty be positioned as useful considerations when thinking about the



susceptibility of the estimate to error or fraud, or “what could go wrong”. They can usefully inform the auditor’s assessment of the identified risks of material misstatement at the assertion level, but should not be the *basis* for identifying those risks and how to design a response. This is consistent with how risk factors are used in ISA 240 and also how they have been incorporated into the proposed PCAOB standard.

A more intuitive way to organise the proposed responses to assessed risks

We agree that there is merit in being more specific in the standard about areas on which the auditor should obtain evidence when testing how management made the accounting estimate. This will help the auditor identify the various components of the estimation process on which it may be necessary in the circumstances to obtain audit evidence.

However, our field testing showed that the structure of the requirements for responding to assessed risks is not intuitive. While most could reconcile the procedures they considered appropriate in the circumstance to the matters for which evidence was required to be obtained, the ED was not presented in the way that auditors think about how to design an audit approach. There was confusion over why matters were listed under certain factors rather than others in paragraphs 17-19 and a lack of clarity about how to address the inter-relationships between them. In addition, it was unclear whether paragraphs 17-19 necessarily all applied to both testing management’s process and to the auditor developing a point estimate or range independently.

Equally important, we believe there may be an unintended risk that focusing on risk “factors” and obtaining evidence about “matters” may cause the auditor to lose focus on adequately responding to the risk of material misstatement at the assertion level. More specifically, the requirements to respond to each of these factors and matters may promote a checklist approach to performing procedures without carefully thinking about whether those procedures, and evidence obtained, provide sufficient appropriate audit evidence about the specific risks of material misstatement at the assertion level.

Our field testing also found that engagement teams were confused by the differentiation between the proposed responses for “low” inherent risk and “other than low” inherent risks. This was because the approaches listed in paragraph 15 are equally applicable when designing a response to any estimate not just low inherent risk estimates.

Therefore, similar to the PCAOB’s approach, and irrespective of the level of assessed risk, we recommend that the standard include an initial requirement to establish the overall testing strategy based on one or more of the potential approaches – testing subsequent events, testing management’s process, developing the auditor’s own point estimate/range.

We also recommend that the original “matters”, set out in paragraphs 17-19 of the ED, for which the auditor is required to obtain evidence, be restructured more logically and intuitively under sub-headings of “method”, “data” and “assumptions”. These would then form revised requirements addressing the matters for which the auditor obtains evidence when testing how management made the accounting estimate and the data on which it was based. We also recommend introducing requirements that set out matters to be considered when obtaining evidence from subsequent events and when developing an auditor’s point estimate/range. In appendix 2 we illustrate how this could be achieved.

Bring scalability to life through application material rather than the proposed low inherent risk threshold

We are very supportive of both the concept of scalability and of the objective of demonstrating scalability more explicitly in the revised ISA. But we do not believe that doing so through introducing a threshold of “low inherent risk” works. Simply stating that the auditor applies the options available under today’s ISA does not bring the genuine scalability some are seeking.



Scalability is, in our view, best addressed by establishing principles-based standards and allowing auditors to apply them by tailoring them to the circumstances and modifying the nature, timing and extent of procedures to be responsive to the assessment of risk. Using conditional requirements, and requirements focussing on where evidence needs to be obtained (rather than the specific procedures to obtain it), allows for appropriate tailoring to the circumstances.

The best way to illustrate scalability in ISA 540 is through application material that can bring the scalability to life by demonstrating what might be an appropriate approach to a simple, non-complex estimate. For example, application material could be added to explain how events occurring up to the date of the auditor's report may provide robust evidence about the estimate, or how re-performing a simple straight forward calculation, such as depreciation, or using a simple, straightforward analytical procedure can provide reliable evidence for a less complex estimate, such as a basic bonus accrual.

In conclusion, we support the IAASB's objectives in revising ISA 540. To achieve the desired outcomes, however, we believe that it is essential that the revised standard: is understandable and capable of practical application; supports high quality audit procedures and the application of appropriate professional scepticism; and addresses fundamental questions about the nature and extent of audit evidence the auditor needs to obtain as a basis for their conclusion on the reasonableness of accounting estimates.

We believe the IAASB has made good progress in this ED towards achieving these aims. But the proposed structure and logic in the ED needs to be revised. The requirements, as drafted, are not how an experienced auditor thinks about how to logically audit an accounting estimate, are not easy to apply in practice and may, therefore, result in unintended consequences. As explained above and illustrated in the appendices, we believe that it is possible to restructure the requirements to address these concerns, without losing the valuable additional guidance that has been developed. Restructuring them into a more logical and intuitive structure will, in our view, result in a robust, high quality auditing standard that will further contribute to enhancing audit quality.

As a final comment, we note the cooperation between the IAASB and PCAOB, primarily through outreach and the PCAOB's participation in the ISA 540 Task Force, in developing this ED. It is clearly in the public interest to reach solutions that can bring about consistent, high quality auditing standards when addressing the same or similar subject-matters and auditing concepts. It is unfortunate that the EDs issued by each board on the subject of auditing accounting estimates contain quite fundamental differences in approach. In our view, this risks confusion and will not help bring consistency in practice to how accounting estimates are addressed in the audit.

In responding to the feedback on this ED, and in finalising the revised ISA, we therefore strongly encourage both the IAASB and PCAOB to work closely together to achieve close alignment in their respective final standards.

We would be happy to discuss our views further with you. If you have any questions regarding this letter, please contact Diana Hillier, at diana.hillier@pwc.com, or me, at richard.g.sexton@pwc.com.

Yours sincerely,

A handwritten signature in blue ink that reads 'Richard G. Sexton'.

Richard G. Sexton
Vice Chairman, Global Assurance



cc: PCAOB

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Responses to specific questions

1. Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?

Given the need for the ISA to remain framework neutral, it is challenging to include very specific requirements linked to a specific framework. However, in our view the changes made address important concepts that are common to financial reporting frameworks, including a heightened focus on data, assumptions and disclosures.

The proposed risk factors of complexity, the need for the use of judgement and estimation uncertainty are useful considerations when thinking about the susceptibility of the estimate to error or fraud, or “what could go wrong”. However, we comment in question 4 on why we believe the way in which the factors have been incorporated into the standard does not result in an effective approach to identifying and assessing the risks of material misstatement at the assertion level, and responding to those risks.

The proposed amendment to ISA 500 to address external information sources and the importance of assessing the relevance and reliability of information obtained from sources outside of the entity also helps in focusing attention on new sources of data and information that evolving financial reporting frameworks will require entities to make use of in determining certain accounting estimates, for example expected credit losses.

In thinking about evolving financial reporting framework requirements and whether the ISA addresses relevant considerations, it is also critical to consider expectations of users, including regulators, about what is needed to comply with those financial reporting requirements, in particular disclosures. And, as a consequence, what is therefore expected of auditors in terms of “how much evidence is enough”. At its heart, where there has been debate on the audit of accounting estimates this often relates to questions about what constitutes sufficient appropriate audit evidence in particular circumstances – for example, what evidence is needed to demonstrate that the auditor has sufficiently challenged managements’ assumption or in relation to information from external information sources. We believe that greater specificity of matters on which the auditor needs to obtain evidence in designing appropriate responses to assessed risks of material misstatement is a useful step-forward in helping to resolve those fundamental questions.

2. Do the requirements and application material of ED-540 appropriately reinforce the application of professional scepticism when auditing accounting estimates?

We support the need to ensure that the standard provides a strong foundation that supports the appropriate application of professional scepticism. Evaluating the relevance, reliability and sufficiency of evidence and providing robust challenge to management in areas of subjective judgement are critical elements in auditing accounting estimates. That is best achieved through the nature of the requirements rather than statements that remind or reinforce the importance of the concept.

We believe the revised requirements in the proposed ISA will encourage a more detailed understanding of how accounting estimates are determined by management. That, alongside the requirements we have suggested in appendix 2 on the identification and assessment of, and response to, risks, will focus the auditor to think more about the reasons for the assessment given



to risks of material misstatement and where audit procedures need to be targeted to obtain sufficient appropriate audit evidence. We also support the additional focus on consideration of management bias and the proposed stand-back evaluation to assess the sufficiency of evidence obtained.

As noted in our response to question 1, we believe it is also important to address questions regarding the sufficiency of audit evidence in areas in which there has been debate. The proposed requirements and guidance regarding what is expected in relation to assumptions, data and information from external information sources are helpful in this regard.

3. Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?

We recognise and support the need to better articulate how the requirements of ISA 540 can be applied in a scalable manner to the very broad range of estimates that fall within the scope of the standard.

But we do not believe that doing so through introducing a threshold of “low inherent risk” works. The results of our field testing indicated that auditors found paragraph 15(a) confusing because there was little guidance on how those approaches can be applied in a scalable manner. In their view, the approaches set out in paragraph 15(a) are applicable to the response to all estimates, not just those with low inherent risk, and they would ordinarily perform procedures to address some of the matters in paragraphs 17-19 even for those lower risk estimates. Overall, auditors were unclear on what is expected if selecting one or more of the approaches under this requirement.

Furthermore, simply stating that the auditor applies the options available under the current ISA, absent any additional clarification of how the auditor applies those approaches in a scalable manner, does not, we believe, bring the genuine scalability some are seeking.

Scalability is, in our view, best addressed by establishing principles-based standards and allowing auditors to apply them by tailoring them to the circumstances and modifying the nature, timing and extent of procedures to be responsive to the assessment of risk. Using conditional requirements, and requirements focussing on where evidence needs to be obtained (rather than the specific procedures to obtain it), allows for appropriate tailoring to the circumstances.

We suggest that the application material could better illustrate scalability in responding to assessed risks through providing further explanation and examples about what may be involved in obtaining sufficient appropriate evidence for simpler accounting estimates. For example:

- how events occurring up to the date of the auditor’s report may provide robust evidence about the reasonableness of the estimate,
- re-performing a simple calculation, such as depreciation, or
- using a simple, straightforward analytical procedure to obtain evidence about a less complex estimate, such as a basic bonus accrual.

Removing the low inherent risk threshold will, in our view, also eliminate the very significant potential for subjective disagreements between auditors and audit inspection bodies as to the auditor’s determination of whether a risk is, or is not, subject to low inherent risk. What is of more importance than such a label is whether the audit response is commensurate to the assessed risk. Recognising that risks exist along a spectrum, we believe it is preferable to reinforce the principle, as set out in the second part of proposed paragraph 15, that the higher the assessed risk the more persuasive the audit evidence needs to be. As suggested above, this could be brought to life in examples within the application material.



We also believe that a more prominent focus on testing events subsequent to the balance sheet date, when those provide sufficient appropriate audit evidence alone, would boost the perception of scalability.

4. **When inherent risk is not low (see paragraphs 13, 15 and 17–20):**
- a) **Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?**
 - b) **Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?**
 - c) **Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?**

We believe a focus on complexity, judgement and estimation uncertainty, and the associated guidance included in the ED, are useful considerations that will promote more granular thinking about of “what could go wrong”, to inform the auditor’s risk assessment at the assertion level and design of appropriate responses. These factors can influence the assessment of identified risks (e.g., whether the risk of misstatement at the assertion level is low, or higher, or a significant risk) and how best to design further audit procedures to obtain evidence in response to the risk. In our field testing, teams agreed that these were important things to think about.

The factors are, however, not what could go wrong i.e., the estimate is not misstated because it is complex or needs judgement. We continue to believe that identifying and evaluating the risk of material misstatement for account balances, classes of transactions, and disclosures at the assertion level remains appropriate. The assertions identified in ISA 315 (e.g., existence, completeness, accuracy, valuation) are the ways in which an account balance can be misstated.

We are therefore concerned that the way in which paragraph 13 is drafted and, more specifically, the fact that the related response to risk requirements (paragraphs 17-19) are driven by each factor, creates an artificial structure for designing an appropriate response to identified risks and is not straightforward to apply in practice.

Equally important, we believe there may be an unintended risk that focusing on risk “factors” and obtaining evidence about “matters”, may cause the auditor to lose focus on adequately responding to the risks of material misstatement at the assertion level. More specifically, the requirements to respond to each of these factors and matters may promote a checklist approach to performing procedures without carefully thinking about whether those procedures, and evidence obtained, provide sufficient appropriate audit evidence about the specific risks of material misstatement at the assertion level.

The results of our field testing indicated confusion about how to categorise each identified risk based on complexity, judgement and estimation uncertainty, when these factors are not mutually exclusive, as well as confusion, therefore, as to which factors are the reasons for the assessed level of risk, including how they impact that assessment individually and in combination (“the reasons for the assessment given to the risk”), which is problematic as that drives the application of paragraphs 17-19.



Based on the results from field testing, the proposed approach will result in documentation of a complex matrix of the assessment of each risk; on the one hand by assertion (as required by ISA 315) and on the other hand based on each of these three risk factors. We believe this will cause confusion and will not enhance the auditors' risk assessment or audit response.

Our field testing also identified the following challenges in applying the new requirements:

- The focus on factors may result in the broader understanding of the entity in ISA 315, as supplemented by paragraph 10 of ISA 540, being overshadowed. There is no clear linkage in paragraph 13 back to paragraph 10 and the list of matters about which the auditor was required to obtain an understanding, to help inform their risk assessment. This may also lead to confusion about how to relate the risk factors in paragraph 13 to the understanding obtained in accordance with paragraph 10 in performing the risk assessment.
- The structure of the requirements on responding to assessed risks is not intuitive and there is a lack of clarity about how to address inter-relationships between the factors. For example, the extensive overlap between paragraphs 17 and 18 caused confusion. The distinction between, for example, paragraph 17(a) and paragraph 18(a)(i) is not clear.
- There was also confusion over why items are listed under certain factors (paragraphs 17-19). For example, there are matters about which it was expected that it would always be relevant to obtain evidence when testing management's process e.g., the appropriateness of changes from the prior year. This is only explicitly addressed under the "judgement" factor requirement. Similarly, there was feedback that a number of matters in paragraph 17 were more broadly relevant (e.g., relevance and reliability of data or accuracy of calculations) and were not exclusive to "complexity". There is therefore a risk of unintended consequences that if a risk factor is not deemed to be the reason for the assessed risk, that "expected" procedures, and the related audit evidence they would provide, are overlooked.

We believe it is important to maintain a strong link to the requirements of ISA 315 and ISA 330. There is a risk that the multitude of concepts being incorporated into proposed ISA 540, including the risk factors and "matters" about which the auditor needs to obtain evidence, risks confusion as to what the auditor is responding to.

We recommend that the understandability and practical application of the ISA can be enhanced by:

- Positioning the proposed risk factors of complexity, the need for the use of judgement and estimation uncertainty as useful considerations when thinking about the susceptibility of the estimate to error or fraud, or "what could go wrong". They can help inform the auditor's identification and assessment of the risks of material misstatement at the assertion level, but should not be the basis for that assessment and response. This is consistent with how risk factors are used in ISA 240 and also how they have been incorporated into the proposed PCAOB standard. See proposed paragraph 13 in appendix 2.
- Adopting a more intuitive structure for the response to assessed risks that better reflects the way in which audits of accounting estimates are actually approached. The three approaches available to the auditor, regardless of the level of assessed risk, are those set out in paragraph 15(a). We believe an overarching requirement, similar in nature to that



proposed by the PCAOB³, is appropriate to direct the auditor in determining an appropriate approach to respond to the assessed risks. See proposed paragraph 15 in appendix 2.

- Incorporating requirements that provide further direction for each of the 3 approaches, as explained further below.
- With respect to testing events subsequent to the balance sheet date, giving this greater prominence. If this approach is capable of providing sufficient appropriate audit evidence then this would, in most cases, be the most sensible approach. A requirement to directly address obtaining evidence from this approach, that precedes requirements under other approaches, appears warranted and would also, in our view, promote an element of scalability. See proposed paragraph 15A in appendix 2.
- With respect to testing management’s process, reorienting paragraphs 17 and 18 to individually address the method, data and assumptions. Both of the proposed ED paragraphs largely focus on these “elements” of accounting estimates but, as noted, contain significant overlap. Restructuring would, in our view, eliminate this overlap, avoid any commonly “expected” procedures being overlooked by subjective judgement as to applicability of a particular factor, and represent a more intuitive approach to thinking about how to respond to risks arising from the key elements of accounting estimates. See proposed paragraphs 15B and 17-18A in appendix 2.
- Creating a more explicit requirement that addresses expectations of the auditor when developing their own point estimate or range. While application material discusses broadly how an auditor might go about developing their own estimate or range we think it is more helpful to indicate the expected work effort if, for example, the auditor uses management’s method or model, data or assumptions. Similarly, setting a clear benchmark in the requirements that, if the auditor uses their own method, model, data or assumptions, they need to have a reasonable basis for those selections would also be appropriate. See proposed paragraph 19B of appendix 2. Note, some further restructuring of the ordering of paragraphs 19 (estimation uncertainty), 20 (auditor ranges) and our suggested additional requirement regarding point estimates or ranges is likely necessary.

These changes will necessarily result in amendments to the application material, including amending the guidance to align to the repositioning of complexity, need for use of management judgement and estimation uncertainty from being the reason for the risk assessment to a consideration influencing the assessment of an identified risk.

5. Does the requirement in paragraph 20 (and related application material in paragraphs A128–A134) appropriately establish how the auditor’s range should be developed? Will this approach be more effective than the approach of “narrowing the range”, as in extant ISA 540, in evaluating whether management’s point estimate is reasonable or misstated?

We support the intent of paragraph 20 and the revised language in part (b). The concept of “narrowing the range” in the extant ISA was criticised by some as being disingenuous. With respect to part (a), it is unclear as to the specific intent of the phrase “are supported by the audit evidence”. There is uncertainty as to whether the reasonableness of the range was to be assessed

³ Proposed AS 2501 paragraph .07



based on audit evidence obtained from the procedures performed in, for example, testing management’s assumptions, data etc., or if this requirement is implying that there is a need to obtain some further additional level of evidence. We believe the intent was the former and that this could be clarified simply in the application material. This would also hold true for when the auditor used their own assumptions or data, and a link back to both our proposed amended requirements (see question 4) in that regard would be useful.

While we find much of the application material to be useful reminders, in particular the focus on bias and the reasonableness of the disclosures, we do not anticipate any real change in practice in respect of the boundaries of the ranges that are developed. Assuming an appropriate work effort has been performed on the relevant inputs/elements of an accounting estimate (method, data, assumptions), the inherent estimation uncertainty associated with certain accounting estimates is such the range of reasonably possible outcomes is very broad and may exceed materiality. The auditor cannot “audit away” inherent estimation uncertainty. We therefore support paragraph A134 and the importance of transparent disclosures about estimation uncertainty in the financial statements.

We also note that there may be some circumstances where the auditor is not able to obtain sufficient appropriate audit evidence about the estimate because the company does not have adequate processes in place to make a reliable estimate. Similar to the positions take in ISA 700 paragraphs 23 and A23 regarding omitted disclosures, and ISA 570 paragraphs 24 and A35 regarding going concern assessments, if management has not made the estimate themselves, or does not have adequate processes to do so, it may not be practicable for the auditor to develop a point estimate or a supportable range. A qualified or disclaimer of opinion may be appropriate because the auditor may simply not be able to obtain sufficient appropriate audit evidence about the estimate. We believe it would be useful to mention this in the application material, for example against paragraph 19 (b).

Finally, we were surprised by the assertion in paragraph A128 that when an auditor develops a point estimate or uses an auditor’s range, the auditor is designing and performing a substantive analytical procedure. While the auditor is required to develop an “expectation of recorded amounts or ratios” when performing an analytical procedure in accordance with ISA 520, the type of point estimates or ranges that are often developed in obtaining audit evidence for accounting estimates are, in our view, of a different nature. For example, the auditor may use an actuary to make an independent actuarial valuation of a pension obligation, or reperform management’s process. These are procedures that provide persuasive and reliable audit evidence that is more akin to the nature of evidence obtained in a test of detail. Extant ISA 540 did not equate making a point estimate or auditor’s range to ISA 520 analytical procedures and we do not believe it is appropriate for the revised ISA 540 to do so either. Furthermore, we believe that categorising an auditor’s point estimate or range as a substantive analytic procedure has the effect of requiring the auditor to perform additional tests of details in the event that the relevant assertion(s) of an estimate being tested has been assessed as a significant risk (ISA 330 paragraph 21). We believe in many cases the procedures performed in developing an auditor’s point estimate or range are, themselves, tests of details which provide sufficient appropriate audit evidence to address such a significant risk.

- 6. Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate?**



If an auditor's point estimate or a range is considered to be a substantive analytic (paragraph A128), it would be inconsistent to use a point estimate or range to identify a misstatement as described in the guidance in paragraphs A143 to A145.

However, if an auditor's point estimate or a range is considered, as we believe, to be a test of detail, we support the application material in paragraphs A142-A146, in particular paragraph A145. When the auditor develops a range that includes reasonably possible outcomes supported by the audit evidence and management's point estimate falls outside of that range, the misstatement cannot be anything other than the difference between management's point estimate and the nearest point on the auditor's range. Any suggestion that the misstatement is to a particular point in the auditor's range implies the auditor is capable of developing a point estimate, which in many cases is not possible and the reason why a range was developed. Further, auditors cannot be expected to introduce more precision than is inherent in the requirements of the applicable financial reporting framework.

Similarly, when management's point estimate does fall within the auditor's range then we agree that there is no misstatement. It is important that the auditor understands how management selected their point estimate and, taking into consideration the audit evidence obtained, whether such selection is consistent with the audit evidence. Any obvious indicator of bias or selection of an amount within a range that is inconsistent with audit evidence obtained or decisions taken with respect to other accounting estimates should be challenged. We therefore support the related application material (A147-A152) addressing potential bias.

With respect to paragraph 23, it is unclear whether the requirement sets an expectation of determining that each accounting estimate is reasonable or misstated, as opposed to "the accounting estimates and related disclosures" collectively. The language used is not clear as is the positioning of the requirement relative to paragraph 22, which clearly and explicitly states that it applies to "each" accounting estimate (that is subject to paragraphs 17-19).

In our view this evaluation has to be for each accounting estimate. Each estimate is being subject to procedures to enable the auditor to reach that conclusion. The "collective" assessment of reasonableness, including consideration of bias, can only take place when considering the financial statements as a whole, and that is, correctly, best addressed in ISA 700. See our recommendations in appendix 2.

7. With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?

It is entirely appropriate that information used as audit evidence be assessed as to its relevance and reliability. In practice, given the broad range of external information sources that exist, further guidance may be needed on the nature and extent of the auditor's work effort in satisfying this requirement, particularly in situations where the availability of evidence may be limited given the source of the information. We believe there could be a stronger and more explicit link in ISA 540, specifically the response to risks, to the proposed new content in ISA 500. While paragraphs A82 and A83 highlight the potential risks relating to external information sources (and could also reference ISA 500), there is no equivalent material in the risk response section. A short application paragraph to accompany each of the requirements addressing assumptions and data, drawing this important link, seems appropriate. We have also suggested a more direct link within the requirements – see proposed paragraph 19A in appendix 2.



There are also likely to be challenges in making the determination/distinction between an external information source and a management's expert depending on the nature of the information being provided to the entity. Therefore, we welcome the examples provided in application material.

We also believe the intent of the ED is unclear in situations when both management and the auditor use the same information source, specifically whether this is acceptable or if other procedures are expected when this is the case. We believe the level of evidence that is appropriate in the circumstances should be correlated to the nature of the information source, and what that information is being used for, rather than focusing on whether the auditor uses the same source or not.

Lastly, with respect to the definition of external information source, we caution that the reference to "publicly available" is at risk of being misunderstood, notwithstanding application paragraph A1, and risks inadvertently narrowing the intended scope of the definition. We suggest deleting the words "publicly available" from the definition and using the application material to explain that the information is available to a "broad range of users upon request".

8. In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

- a) Translations — Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-540.**

No comments.

- b) Effective Date — Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.**

We support an effective date of financial periods ending approximately 18 months after final approval of the ISA and that the usual permission to early adopt be maintained.

Other Comments

Terminology

- It is important, to avoid unintended confusion, that terminology be applied consistently throughout the ISA. For example, paragraph 3(c)(ii) continues to use the term "appropriate" in relation to management's selection of a point estimate and disclosures. This is unhelpful given the term "reasonable" is applied to these same matters in the objective of the ISA.
- We note the explanation in the explanatory memorandum that there is inconsistency in terminology between proposed ISA 540 and ISA 700 (Revised) with respect to the use of the term "reasonable" or "adequate" as related to disclosures. The ISAs were only recently amended with respect to the auditor's responsibilities related to disclosures and we caution against making



further changes again so soon. We support a focus on whether “accounting estimates *and related disclosures* made by management are reasonable in the context of the applicable financial reporting framework” and a corresponding amendment could be made to ISA 700 paragraph 13(c). However, we would not recommend amending paragraph 13(e) of ISA 700 (Revised) to broaden it to reflect “financial statement disclosures being reasonable” as we do not believe that sufficient consideration has been given to the possible unintended consequences.

- There are a few places where the terms “back testing”, “model overlay” and “reverse stress testing” are used. It would be useful to include an explanation of what is meant. These terms are not necessarily widely used and understood by all auditors.

Understanding the Entity and Internal control

- Our field testing indicated some lack of clarity about what is expected by the new requirement in paragraph 10(c). How this differs from paragraph 10(a) was not clear. The distinction between this and understanding what has been included and how management made those estimates is too subtle and teams didn’t know what to document to satisfy the requirement. We recommend that this “independent” consideration be moved to a new requirement focused on engagement team discussion of potential risks of material misstatement. See proposed paragraph 11A in appendix 2.
- The language used in paragraph 10(f) can be read as implying some separate consideration of internal control, specific to accounting estimates, beyond what is required in ISA 315. In seeking to eliminate this confusion, we have recommended alternative language that is more direct and focuses on understanding the relevant controls and extent of governance and oversight that exists, which should have been obtained in complying with ISA 315. See proposed paragraph 10 in appendix 2. We also note that, with the concurrent revision of ISA 315, it may be appropriate for additional content to be added to that standard to better explain key considerations relating to accounting estimates. However, we are not proposing a wholesale relocation of paragraph 10 to ISA 315 as we acknowledge the established structure adopted in developing these “subject-matter” specific ISAs is to address the end-to-end audit process.

Specialised skills

- We are not convinced of the necessity for a separate requirement to determine whether specialised skills or knowledge are required in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. In using the work of a specialist in the audit, the auditor needs to have a sufficient understanding to be able to evaluate their work. While the auditor may wish to involve specialists in planning the audit, they can and should be in a position themselves to evaluate risks of material misstatement. This is likely to result in boilerplate documentation. At a minimum we recommend consolidating the two requirements addressing the potential use of specialists (paragraphs 12 and 14) such that identification and response to risks are addressed in one holistic requirement. See proposed paragraph 12 in appendix 2.

Significant risks

- Based on the results of our field testing we concur with the decision not to include any specific additional requirements unique to responding to significant risks related to accounting estimates. Engagement teams did not identify any specific responses where they would expect to perform additional or different procedures to those required by the ED if the risk had been identified as significant. As noted in our question responses, the same approaches are adopted to test estimates regardless of level of risk. It is the extent (rigour) of those procedures that varies. We



have, however, suggested reinforcing some of the key principles from ISA 330. See paragraph 15 in appendix 2.

Bias

- We agree that paragraph 24 needs to be assessed at the collective “estimates” level to be able to judge bias across the entire population of estimates, as some bias may only emerge at that level. This requirement does overlap considerably with the equivalent requirement in ISA 700 (Revised) and we have therefore recommended making this link more explicit. See proposed paragraph 24 in appendix 2.
- In paragraph A7, the statement is made that the susceptibility of an accounting estimate to management bias increases with the extent to which there is a need for judgement in making the accounting estimate. Simply needing judgement does not necessarily make an estimate susceptible to bias, rather it is the extent to which the accounting estimate is influenced by management judgement.

Documentation

- As explained in this letter, we have concerns over what is expected in respect of documentation of:
 - Paragraph 10(c) - The auditor’s independent expectation of the nature of the accounting estimates the auditor expects to be included in the financial statements;
 - Paragraph 10(f) – internal control;
 - Paragraphs 12 and 14 – Determination of the need for specialised skills or knowledge;
 - Paragraph 13 - Risk assessment;
 - Paragraph 15 – Judgement on “low/not low” inherent risk;
 - Paragraphs 17-19 – How procedures performed address these requirements given their inherent inter-relationship;
 - Paragraph 23 – Level at which the evaluation is performed.

Other comments on proposed guidance in the application material

- The application guidance includes a number of considerations specific to smaller entities, as is done in other ISAs. In some cases, however, the guidance applies to any estimate that is not complex, and may not be applicable to estimates in a smaller entity that are complex. It is the nature of the estimate that is relevant to the guidance rather than the size of the entity.
- In paragraph A23, it is equally important to note that an owner-manager may not have the requisite knowledge and experience to identify the need for an estimate or to make the estimate. This may increase the risk of material misstatement.
- In a few places (e.g., paragraph A30), the guidance implies that expected credit loss models are necessarily complex. While this is likely to be the case in, for example, an expected credit loss model for a large portfolio of commercial loans, there are circumstances when the model need not be complex (e.g., smaller entities with a basic debtor portfolio).
- In paragraph A33, the variability and timing of future cash flows are provided as examples of assumptions outside of management control, but as management usually can influence them, this does not seem like a good example.



- The point being made in paragraph A89 could be clearer – that auditors should not make decisions based solely on the amount recognized or disclosed, as the estimation uncertainty associated with an otherwise immaterial amount could result in the potential for material misstatement.
- We suggest that paragraph A92 be reconsidered as it could inadvertently be suggesting that auditors do need to obtain audit evidence for assumptions to which the estimate is not sensitive.
- Paragraph A95 includes a statement that the ISA does not imply or require a separate assessment of inherent risk. In light of the paragraph 15(a) requirement this statement is factually incorrect. However, as noted above, we recommend eliminating the low inherent risk threshold, which would mean that this paragraph in the application material, as well as paragraph A96, is no longer necessary, while others will require amendment.
- In paragraph A100, it is unclear whether the point being made is that there may be few controls related to accounting estimates that are relevant to the audit, or that the auditor may decide that it will be more effective and efficient to perform substantive procedures than obtain evidence by testing controls.
- Paragraph A101 seems to be suggesting that the auditor is expected to be able to definitively determine whether alternative valuation concepts, techniques or factors, types of assumptions or sources of data are more “appropriate” or “generally accepted”. In some circumstances, alternatives may be equally reasonable and acceptable in the circumstances.
- Paragraph A125 makes the point that the auditor’s consideration of estimation uncertainty associated with an accounting estimate and its related disclosure may be a matter that required significant auditor attention and, therefore, may constitute a key audit matter. There are many aspects of the audit of an accounting estimate that could require significant auditor attention and, therefore, be considered a key audit matter. It seems incomplete to focus solely on estimation uncertainty.
- In paragraph A127 it would be useful to also mention that if management has not appropriately understood or addressed the estimation uncertainty, this is likely to constitute a control deficiency. We suggest making a cross reference made to the auditor’s related communication responsibilities in ISA 265.

Detailed Drafting Recommendations

Requirements

Risk Assessment Procedures and Related Activities

10. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including its internal control, as required by ISA 315 (Revised), the auditor shall obtain an understanding of the following: (Ref: Para. A9–A10)
 - (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including the recognition criteria, measurement bases and the related presentation and disclosure requirements. (Ref: Para. A11–A13)
 - (b) Regulatory factors, if any, relevant to accounting estimates. (Ref: Para. A14–A15)
 - (c) ~~The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements. (Ref: Para. A16–A17)~~ [*Relocated to proposed paragraph 11A*]
 - (d) 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, accounting estimates. (Ref: Para. A18–A23)
 - (e) How management makes accounting estimates, including: (Ref: Para. A24–A25)
 - (i) The methods used, how they are selected or designed, and how they are applied, including the extent to which they involve modelling; (Ref: Para. A26–A31)
 - (ii) The process used to select assumptions, including alternatives considered and how management identifies significant assumptions; (Ref: Para. A32–A38)
 - (iii) The process used to select data, including the source(s) of that data and how management identifies significant data; (Ref: Para. A39–A42)
 - (iv) The extent to which management has applied specialized skills or knowledge, including whether a management's expert has been used; (Ref: Para. A43–A44)
 - ~~(v) How the risk of management bias is identified and addressed; (Ref: Para. A45)~~ [*Relocated to point (f)*]
 - (vi) How management has addressed estimation uncertainty; and (Ref: Para. A46)
 - (vii) How management has addressed the need for a change from the prior period in the methods, assumptions or data used, and if so, the nature of, and reasons for, such changes. (Ref: Para. A47).
 - (f) Each of the components of Relevant internal control as they related to making accounting estimates, including the nature and extent of oversight and governance that the entity has in place over management's process, including controls that address the potential for management bias in making significant judgments. (Ref: Para. A48–A60)



11. The auditor shall review the outcome of accounting estimates included in the previous period financial statements, or, where applicable, their subsequent re-estimation to assist in identifying and assessing the risk of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made. (Ref: Para. A61–A66)
- 11A. In discussing the susceptibility of the entity’s financial statements to material misstatement, as required by ISA 315⁴, the engagement partner and other key engagement team members shall discuss, based on the understanding obtained, the nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity’s financial statements, and how and where the entity’s accounting estimates may be susceptible to material misstatement due to fraud or management bias. (Ref: Para. A16–A17)
12. Based on auditor’s understanding of the nature of the accounting estimates and related disclosures included in the entity’s financial statements, the auditor shall determine whether specialized skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement, design and perform audit procedures to respond to those risks, or evaluate the audit evidence obtained. (Ref: Para. A67–A70)

Identifying and Assessing the Risks of Material Misstatement

13. In identifying and assessing the risks of material misstatement, as required by applying ISA 315 (Revised), the auditor is required to shall identify and assess the risks of material misstatement, at the financial statement and assertion level in relation to accounting estimates (whether recognised or disclosed in the financial statements) and related disclosures, including determine determining whether any of the risks of material misstatement identified are, in the auditor’s judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate In making this risk assessment, the auditor shall take into account: the extent to which the accounting estimate is subject to, or affected by, one or more, relevant factors, including: (Ref: Para. A71–A78)
 - (a) The complexity of the method used for making the accounting estimate, including the use of models;
 - (b) The number, complexity and source of significant assumptions and significant data used in making the accounting estimate;
 - (c) The extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the assumptions and data used.

(a) Complexity in making the accounting estimate, including:

 - (i) The extent to which the method, including modelling, involves specialized skills or knowledge; and (Ref: Para. A79–A81)
 - (ii) The difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data; (Ref: Para. A82)

(b) The need for the use of judgment by management and the potential for management bias, including with respect to methods, assumptions, and data; and (Ref: Para. A83–A85)

⁴ ISA 315, paragraph 10



~~(c) Estimation uncertainty, including the extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the assumptions and data used. (Ref: Para. A86–A93)~~

- ~~14. In responding to the assessed risks of material misstatement related to accounting estimates, the auditor shall determine whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures. (Ref: Para. A67–A70) [Now merged with proposed paragraph 12]~~
15. In applying ISA 330, the auditor is required to designing and perform further audit procedures to respond to the assessed risks of material misstatement, as required by ISA 330, the auditor shall design an approach to testing the accounting estimate that is responsive to the reasons for the assessment in paragraph 13 and that includes one or a combination of the following approaches: including significant risks, at the assertion level. In doing so: (Ref: Para A94–A95)
- (a) Obtaining audit evidence about events occurring up to the date of the auditor’s report;
 - (b) Testing how management made the accounting estimate and the data on which it is based; or
 - (c) Developing a point estimate or range based on available audit evidence to evaluate management’s point estimate.

The approach shall take into account that more persuasive audit evidence is required the higher the auditor’s assessment of risk, and that for risks assessed as significant risks ISA 330 requires the auditor, among other matters, to:

- (a) Test controls in the current period if the auditor plans to rely on controls over a risk; and
- (b) Include tests of details when the approach consists only of substantive procedures.

The auditor shall also design and perform substantive procedures for each material class of transaction, account balance and disclosure, as required by ISA 330, related to accounting estimates, irrespective of the assessed risk of material misstatement.

- ~~(a) When inherent risk is low, the auditor shall determine whether one or more of the following further audit procedures would provide sufficient appropriate audit evidence regarding the assessed risk(s) of material misstatement in the circumstances: (Ref: Para A96)~~
 - ~~(i) Obtaining audit evidence about events occurring up to the date of the auditor’s report;~~
 - ~~(ii) Testing how management made the accounting estimate and the data on which it is based; or~~
 - ~~(iii) Developing a point estimate or range based on available audit evidence to evaluate management’s point estimate.~~
- ~~(b) When inherent risk is not low, the auditor’s further audit procedures shall include procedures to obtain audit evidence about the matters in paragraphs 17–20, when applicable. (Ref: Para A97)~~

The auditor’s further audit procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 13, recognizing that the higher the assessed risk of material misstatement the more persuasive the audit evidence needs to be.



- ~~16. If the auditor intends to rely on controls relating to accounting estimates, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to their operating effectiveness. (Ref: Para A98–A100)~~

Obtaining audit evidence about events occurring up to the date of the auditor’s report

15A. When the auditor obtains audit evidence from events that have occurred up to the date of the auditor’s report, the auditor shall evaluate whether the audit evidence:

- (a) is sufficient, reliable and relevant to the accounting estimate, and
- (b) supports or contradicts the accounting estimate,

taking into account that changes in circumstances and other relevant conditions between the event or transaction date and the measurement date may affect its relevance to the accounting estimate at the measurement date.

Testing how management made the accounting estimate and the data on which it is based

15B. When testing how management made the accounting estimate and the data on which it is based the auditor’s further audit procedures shall include procedures to:

- (a) obtain audit evidence about the method, significant assumptions and significant data used in making the accounting estimate (see paragraphs 17-18A); and
- (b) when applicable, address estimation uncertainty (see paragraph 19).

[Paragraphs 17-18A are not marked as they have been substantially redrafted. Application material references have been excluded as these would require re-mapping.]

Method

17. In responding to the assessed risks of material misstatement identified in accordance with paragraph 13, the auditor shall obtain evidence about:

- (a) whether the method selected for making the accounting estimate is appropriate in the context of the applicable financial reporting framework and changes, when applicable, from previous periods are appropriate;
- (b) whether the calculations are mathematically accurate and appropriately applied; and
- (c) when management’s application of the method involves complex modelling, whether judgments made have been applied consistently and whether, when applicable:
 - (i) the design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;
 - (ii) changes, if any, from the previous period’s model are appropriate in the circumstances; and
 - (iii) adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances.



Significant Assumptions

18. In responding to the assessed risks of material misstatement identified in accordance with paragraph 13, the auditor shall, when the accounting estimate makes use of significant assumptions, obtain evidence about:
- (a) whether the significant assumptions selected for use:
 - (i) are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework and changes from previous periods, when applicable, are appropriate;
 - (ii) gives rise to indicators of possible management bias;
 - (b) whether the integrity of significant assumptions has been maintained in applying the method;
 - (c) whether significant assumptions are consistent with each other and with those used in other accounting estimates or with assumptions used in other areas of the entity's business activities; and
 - (d) when relevant to the appropriateness of the significant assumptions or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.

Significant Data

- 18A. In responding to the assessed risks of material misstatement identified in accordance with paragraph 13, the auditor shall, when the accounting estimate makes use of significant data, obtain evidence about:
- (a) whether the significant data selected for use:
 - (i) is appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework and changes, when applicable, from previous periods are appropriate;
 - (ii) gives rise to indicators of possible management bias;
 - (iii) is relevant and reliable;
 - (b) whether management has appropriately understood or interpreted significant data, including with respect to contractual terms; and
 - (c) whether the integrity of significant data has been maintained in applying the method.

Estimation Uncertainty

19. ~~In complying with paragraph 15(b), when the reasons for the assessment given to the risk of material misstatement include estimation uncertainty:~~ In responding to the assessed risks of material misstatement identified in accordance with paragraph 13, when the accounting estimate is subject to estimation uncertainty the auditor shall:
- (a) ~~The auditor shall~~ Obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework:
 - (i) Management has taken appropriate steps to understand and address the estimation uncertainty, and develop a point estimate that meets the measurement objective; and (Ref: Para. A113–A115)



- (ii) Management's point estimate is ~~reasonable~~, and the related disclosures in the financial statements that describe the estimation uncertainty are reasonable. (Ref: Para. A116–A125)
 - (b) When, based on the audit evidence obtained, in the auditor's judgment, management has not appropriately ~~understood and~~ addressed the estimation uncertainty, the auditor shall, to the extent possible, develop an auditor's point estimate or range to enable the auditor to evaluate the reasonableness of management's point estimate and the related disclosures in the financial statements that describe the estimation uncertainty. (Ref: Para A126–A134)
- ~~20. If the auditor concludes that it is appropriate to develop an auditor's range, the auditor shall only include in that range amounts that:~~
- ~~(a) Are supported by the audit evidence; and~~
 - ~~(b) The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework. [Now addressed through paragraph 19B]~~

External information sources

19A. When management makes use of information from an external information source, the auditor shall consider the relevance and reliability of the information to be used as audit evidence as required by ISA 500⁵.

Developing a point estimate or range

19B. When developing a point estimate or range based on available audit evidence to evaluate management's point estimate, the auditor shall:

- (a) when using some or all of the auditor's own methods, data or assumptions to develop an expectation of the accounting estimate, or range, for comparison to the entity's accounting estimate:
 - (i) Have a reasonable basis for the assumptions or method used;
 - (ii) Evaluate the relevance and reliability of any data or assumptions obtained from an external information source in accordance with ISA 500.
- (b) when using the entity's methods, or using data produced by the entity or significant assumptions used by the entity, obtain evidence about the matters in paragraphs 17-19A, as applicable.

Disclosures Related to Accounting Estimates

21. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures related to accounting estimates are reasonable in accordance with the context of the requirements of the applicable financial reporting framework including: (Ref: Para. A135–A138)
- (a) In the case of a fair presentation framework, whether management has provided the disclosures beyond those specifically required by the framework that are necessary to achieve the fair presentation of the financial statements as a whole, or
 - (b) In the case of a compliance framework, whether the disclosures are those that are necessary for the financial statements not to be misleading.

⁵ Proposed ISA 500 (Revised) paragraph 7



Overall Evaluation Based on Audit Procedures Performed

22. In applying ISA 330 to each accounting estimate for which the auditor's further audit procedures are required to address the matters in paragraphs 17–19, ~~†~~ The auditor shall evaluate for each accounting estimate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A139–A141)
- (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, ~~including when indicators of possible management bias have been identified~~;
 - (b) Sufficient appropriate audit evidence has been obtained; and
 - (c) Management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework.
23. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate, for each accounting estimate, whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. In making this evaluation, the auditor shall consider all relevant audit evidence obtained whether corroborative or contradictory. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit. (Ref: Para. A2, A142–A146)

Indicators of Possible Management Bias

24. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, ~~even if they are individually reasonable~~, indicate possible bias on the part of the entity's management, when assessing the financial statements as a whole. When indicators of possible bias are identified, the auditor shall evaluate the implications for the auditor's risk assessment and responses, in accordance with paragraph 22, and take this into account when evaluating whether the financial statements as a whole are free from material misstatement in accordance with ISA 700 (Revised) audit. (Ref: Para. A147–A152)

Written Representations

25. The auditor shall obtain written representations from management and, when appropriate, those charged with governance that they believe the methods, significant data, and significant assumptions used in making the accounting estimates and their related disclosures are appropriate to achieve recognition, measurement or disclosure ~~that is reasonable~~ in accordance with the context of the applicable financial reporting framework. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A153–A154)

Communication with Those Charged With Governance or Management

26. In applying ISA 260 (Revised) and ISA 265, the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate related to the extent to which the accounting estimates and their related disclosures are affected by, or subject to, complexity, the need for the use of judgment by management, estimation uncertainty, or other relevant factors. (Ref: Para. A155–A157)

Documentation

27. The audit documentation shall include:



- (a) The basis for the auditor's evaluation of the reasonableness of the accounting estimates and related disclosures; and
- (b) Indicators of possible management bias, if any, and the auditor's evaluation thereof in forming the auditor's opinion on whether the financial statements as a whole are materially misstated. (Ref: Para. A158–A159)

Summary of approach to field testing

In field testing the proposed requirements set out in the ED we undertook two parallel exercises, as described below:

General – Four engagement teams were asked to: consider the six accounting estimate scenarios presented in the IAASB field testing package; read the new requirements; identify and assess the risks of material misstatement relating to each estimate; and respond to a series of questions that were broadly aligned with those in the IAASB package (see below).

Banking and Insurance – Seven engagement teams were asked to undertake the same exercise as that described above but with the subject-matter being accounting estimates common to their client base/ relevant industry (banking or insurance), rather than the six scenarios presented in the IAASB package. We specifically requested that Expected Credit Losses under IFRS9 be included. The same series of questions were posed, modified, where appropriate, to reflect the different subject-matter.

Questions

1. Did the revised understanding the entity risk assessment requirement (paragraph 10) provide you with sufficient guidance to identify and assess the risks of material misstatement?
2. With respect to the revised requirement to identify and assess the risks of material misstatement (paragraph 13) how capable were you of thinking about the estimate in terms of the risk factors of complexity, the need for the use of judgement and estimation uncertainty?
3. What risk(s) of material misstatement did you identify for each estimate and which risk factor(s) did you determine as being the reason for your assessment?
4. Did you identify any other relevant risk factor(s) when thinking about the risks of material misstatement? If so, please explain.
5. Recognising that risks exist on a spectrum, how easy or otherwise did you find it to make the judgement required under paragraph 15 as to whether inherent risk is low or not low?
6. If you considered the estimate to have low inherent risk, was it clear from paragraph 15 (a) what you would need to do to design an appropriate response to the risk? What sort of procedures did you think were appropriate to respond to the risk? If you determined a different approach than those listed in the requirement please explain (mark N/A if risk is not assessed as low inherent risk).
7. If inherent risk was considered to be 'not low', was it sufficiently clear to you what procedures you would need to perform to obtain evidence about the matters in paragraphs 17-20, as applicable (mark N/A if risk is assessed as low inherent risk)?
8. Did you find that the reasons for the assessed risks included more than one risk factor (complexity, judgement, estimation uncertainty), and, if so, how did you approach addressing paragraphs 17-20? What challenges did you encounter when trying to address multiple factors?



9. In reading each of the new requirements and thinking about the different estimates you had to consider, was it clear to you what you needed to do to comply with each requirement?
10. Did this new approach, based on consideration of “risk factors” and “matters about what audit evidence needs to be obtained, when applicable”, change your overall approach to thinking about risks related to accounting estimates and how best to address them, compared with applying existing ISA 540? If so, what was different?
11. Recognising that risks exist along a spectrum, were you able to tailor the procedures you would perform to the level of assessed risk? If you identified any significant risks, based on the work effort you think would be needed to comply with paragraphs 15-20, would you expect to do anything different/additional as a consequence of the risk being determined as significant?
12. Regarding misstatements, did you find the application material in paragraphs A142-A146 clear in determining what constitutes a misstatement?