IAASB

Staff Audit Practice Alert
June 2020

COVID-19

Auditing Accounting Estimates in the Current Evolving Environment Due to COVID-19

This publication has been prepared to highlight key areas of focus in the current environment when undertaking audit procedures relating to accounting estimates and related disclosures in accordance with the International Standards on Auditing™ (ISA™).

This publication does not amend or override the ISAs, the texts of which alone are authoritative. Reading this publication is not a substitute for reading the ISAs.

Preparers, those charged with governance and users of financial statements may find this publication helpful in understanding the auditor's responsibilities in relation to auditing accounting estimates and related disclosures.

Further support materials related to the financial reporting implications of the COVID-19 pandemic can be found at the International Federation of Accountants' (IFAC) website.[1]

This publication is based on the requirements and guidance in ISA 540 (Revised), which is effective for audits of financial statements beginning on or after December 15, 2019. Auditors performing an audit under extant ISA 540 (e.g., for an entity with a June 2020 year-end) may still find this guidance useful in the current circumstances as ISA 540 (Revised) expands on the extant standard. For example, ISA 540 (Revised) includes more detailed requirements and application material relating to methods (including models), assumptions and data, and the consideration of inherent risk factors that may give rise to risks of material misstatement of an accounting estimate.

The COVID-19 pandemic has widespread global impacts on economies, markets and businesses, giving rise to significant volatility and considerable uncertainty. In such unpredictable circumstances, auditors will need to focus on the potential impacts of this volatility and uncertainty when auditing accounting estimates.

Management's Responsibility for Accounting Estimates and Related Disclosures

Management is responsible for the recognition and measurement of accounting estimates and related disclosures in accordance with the applicable financial reporting framework. Financial reporting frameworks often require forward-looking information as the basis for recognition and measurement, or disclosures, in the financial statements. Because of this, accounting estimates are a fundamental part of the financial statements for many entities.

Given the uncertainties related to the COVID-19 pandemic, it will likely be more difficult for management to determine the assumptions and obtain the data used to develop accounting estimates, in particular future cash flows. The impact on the business environment and global economies from the COVID-19 pandemic could also result in triggers for impairment testing.

[1] IFAC's website also contains further audit considerations arising from the COVID-19 pandemic.

The Auditor's Responsibility for Accounting Estimates and Related Disclosures

ISA 540 (Revised)[2] sets out the requirements for auditors when auditing accounting estimates and related disclosures. Given the current environment, it is likely that additional, or more robust, procedures may be needed when responding to assessed risks of material misstatement in relation to accounting estimates and related disclosures.

In designing and performing audit procedures with respect to accounting estimates and related disclosures, and taking into account the increase in professional judgment needed by management, the exercise of professional skepticism, and the auditor's demonstration thereof, is critical to support the auditor's conclusions.

This Staff Audit Practice Alert focusses on the following areas:

- Risk assessment procedures and related activities;
- Identifying and assessing the risks of material misstatement;
- Responding to assessed risks of material misstatement;
- Disclosures;
- Implications for the auditor's report; and
- Management bias and fraud.

Risk Assessment Procedures and Related Activities

Paragraphs 13–15 of ISA 540 (Revised) describe the risk assessment procedures and related activities required for accounting estimates. These paragraphs refer to and expand on how ISA 315 (Revised)[3] is to be applied. The table below highlights certain matters the auditor may want to focus on when performing risk assessment and related activities with respect to accounting estimates.

Relevant Matter	Examples
Regulatory Factors (ISA 540 (Revised), paragraph 13(c))	As a result of the COVID-19 pandemic there may be: • Temporary changes to the regulatory framework that may need to be understood, and the impact thereof considered. For example, the European Central Bank temporarily eased capital requirements so that banks can help markets function properly during the COVID-19 outbreak. • Initiatives aimed at sustainable solutions for temporarily distressed debtors. • Changes to financial reporting deadlines for entities, which may also extend the period for the auditor's consideration of subsequent events. Movements in assumptions during this period may impact the amounts or disclosures related to accounting estimates.

2 ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

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

Relevant Matter	Examples
Relevant methods,[4] assumptions[5] or data,[6] and the need for changes in them (ISA 540 (Revised), paragraph 13(h)(ii))	In the current environment, it is likely that auditors may need to consider whether management has assessed the continued use of previous methods, assumptions and data, and if not, whether the methods, assumptions and data used remain appropriate. In light of the evolving environment, the following highlights matters the auditor may want to consider: *Methods*[7] • Whether the model has been appropriately changed or adjusted on a timely basis for changes in market or other conditions. Because of the changed environment, previously used models may not be appropriate anymore; • Whether new adjustments have been made, or should have been made, to the output of the model; • Whether the adjustments to the output of the model are appropriate in the circumstances in accordance with the applicable financial reporting framework; *Assumptions*[8] • The basis for management's selection of assumptions. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption; • How management assesses whether the assumptions used are relevant and complete; • When applicable, how management determines that the assumptions are applied consistently across other areas of the financial statements; and

4 A method is a measurement technique used by management to make an accounting estimate in accordance with the required measurement basis. A method is applied using a computational tool or process, sometimes referred to as a model, and involves applying assumptions and data and taking into account a set of relationships between them.

5 Assumptions involve judgments based on available information about matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events.

6 Data is information that can be obtained through direct observation or from a party external to the entity.

7 ISA 540 (Revised), paragraph A39

8 ISA 540 (Revised), paragraph A40

Relevant Matter	Examples
	Data[9] • How management evaluates whether the data used is appropriate. Because of the COVID-19 pandemic, the data used in previous periods may not be appropriate anymore. For example, management may ordinarily use historical credit losses on a large group of trade receivables to estimate expected credit losses on its trade receivables. This data may not be appropriate anymore as the data does not reflect the current economic conditions. Therefore, management may need to use different data, or need to make adjustments to the output of the model (as described above).
Understanding Controls (ISA 540 (Revised) paragraph 13(i))	Although businesses may be operating in different ways to adapt to the current environment, the auditor is still required to obtain an understanding of internal control relevant to the audit (i.e., control activities). This includes, where applicable, relevant controls over management's process for making accounting estimates, for example, whether changes have been made for controls related to the review and approval of accounting estimates. If management has designed new controls, or controls have changed, that are relevant to the audit, the auditor is required to evaluate their design and determine whether they have been implemented.
Specialized skills or knowledge of the engagement team (ISA 540 (Revised), paragraph 15)	As a result of the COVID-19 pandemic, the auditor may determine that the engagement team requires specialized skills or knowledge. For example, the auditor may require the assistance of a valuation expert because current conditions may indicate that industry averages or historical results are no longer appropriate, or may need to be supplemented with other information, to evaluate management's assumptions used in a valuation model (e.g., discount rates). ISA 540 (Revised), paragraph A61, describes matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge.

Identifying and Assessing the Risks of Material Misstatement

ISA 540 (Revised), paragraphs 16–17, describe the identification and assessment of the risks of material misstatement related to accounting estimates. These paragraphs refer to, and expand on, how ISA 315 (Revised) is to be applied in relation to accounting estimates. Depending on the nature of the accounting estimate, the degree of uncertainty in the outcome of events or conditions underlying significant assumptions, and lack of available observable data, are likely to impact the auditor's work in relation to accounting estimates.

9 ISA 540 (Revised), paragraph A44

ISA 540 (Revised) includes inherent risk factors to assist the auditor in identifying and assessing the risks of material misstatement, including:

- Estimation uncertainty;
- Complexity; and
- Subjectivity.[10]

Inherent risk factors may, either individually or in combination, affect accounting estimates to a greater or lesser degree, and assist the auditor to assess inherent risk on the spectrum of inherent risk. The relevance and significance of inherent risk factors may vary from one estimate to another. In the current environment, the effect of the inherent risk factors may be amplified and may result in identified risks being assessed higher or at the higher end of the spectrum of inherent risk, which in turn will influence the persuasiveness of the audit evidence needed in responding to the assessed risks.

In assessing the risks of material misstatement, the auditor may also consider whether previously identified risks are now significant risks[11] in light of the current circumstances.

The table below highlights, for each of these inherent risk factors, matters the auditor may want to consider because of the COVID-19 pandemic, and which may assist with the identification and assessment of the risks of material misstatement.

Inherent Risk Factor	Matter for Consideration
Estimation Uncertainty (ISA 540 (Revised), paragraph 16(a))	As the trajectory and expected duration of the COVID-19 pandemic is uncertain, there may be a wide range of possible outcomes, resulting in a high degree of estimation uncertainty. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. In other cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 540 (Revised), paragraphs A74 and A75, provide further guidance in such circumstances.
Complexity (ISA 540 (Revised), paragraph 16(b))	The degree to which the accounting estimate is subject to complexity may be impacted by the COVID-19 pandemic in different ways: • Governmental support packages or other changed laws or regulations being introduced may result in changes to the measurement of the accounting estimate. • Changes in contractual terms related to the accounting estimate. • The use of a different model to make the accounting estimate because of the availability of observable assumptions.

10 ISA 540 (Revised), paragraph 16

11 If a risk is determined to be a significant risk, there are additional procedures to be undertaken including work on related controls relevant to the audit and communications with those charged with governance.

Inherent Risk Factor	Matter for Consideration
	• Complex financing arrangements may be entered into to support the entity's ability to continue as a going concern. • A new model may need to be developed for the current circumstances.
Subjectivity (ISA 540 (Revised), paragraph 16(b))	Estimation uncertainty gives rise to subjectivity, and hence, the need for the use of judgment in making the accounting estimate. When the degree of estimation uncertainty increases, the degree of subjectivity also increases. The COVID-19 pandemic has resulted in increased subjectivity in: • Assumptions with long forecast periods. • Assumptions based on data that is currently unobservable. • Assumptions based on data that is so volatile that it is not reliable. • Balances where it is difficult to make reliable forecasts about the future. Examples of accounting estimates most likely to be affected include: • Impairment of goodwill, non-financial assets (e.g., intangible) and financial assets (e.g., trade receivables). • Fair value of financial assets (investments and receivables). • Fair value of financial liabilities. • Restructuring liabilities. • Percentage of completion of construction contracts. • Recoverability of deferred tax balances. • Pension assets and liabilities. • Lease obligations. When there is a high degree of subjectivity, the accounting estimate is likely to be more susceptible to management bias (see section on "Management Bias and Fraud" below).

In addition to the matters above, the auditor may consider:

- Whether the assessments of the risks of material misstatement at the assertion level remain appropriate. For example, even if the recoverability of receivables was not considered a potential risk of material misstatement, debtors may not be able to make timely payments in the current environment. Accordingly, auditors may need to reassess previous assessments of the related risk of material misstatement.
- Whether, based on the revised consideration of assessed risks, there may be a need to modify the overall audit strategy and audit plan and thereby the resulting planned nature, timing and extent of further audit procedures. The auditor may also communicate with those charged with governance about such matters.[12]

[12] See ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph A26

Responses to Assessed Risks of Material Misstatement

ISA 540 (Revised), paragraphs 18-30, address responses to the assessed risks of material misstatement of accounting estimates. These paragraphs refer to, and expand on, how ISA 330[13] is to be applied in relation to accounting estimates. ISA 540 (Revised) identifies the following testing strategies:

- Obtaining audit evidence from events occurring up to the date of the auditor's report;
- Testing how management made the accounting estimate; or
- Developing an auditor's point estimate or range.

Because of the effects of the COVID-19 pandemic there may be more instances where audit work is delayed (e.g., owing to the extension of reporting deadlines or in relation to access to information to be used as audit evidence), and therefore audit evidence from events occurring up to the date of the auditor's report may be more readily available. In addition, the pandemic may particularly impact the latter two testing strategies as these approaches require the auditor to perform procedures on the methods, assumptions or data used to make the accounting estimate. The table below highlights some matters the auditor may want to consider in light of the current environment:

Relevant Matter	Matter for Consideration
Methods (ISA 540 (Revised), paragraph 23)	• Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates. Methods used in previous years may no longer be appropriate given the changed circumstances. • When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences. • When applicable, whether adjustments to the output of the model are consistent with the measurement objective of the financial reporting framework and are appropriate in the circumstances. Given the current circumstances, management may need to make different, or more, adjustments than in prior years. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias (see section on "Management Bias and Fraud" below).
Significant assumptions (ISA 540 (Revised), paragraph 24)	• Whether the significant assumptions are appropriate in the circumstances given the nature of the accounting estimate, the applicable financial reporting framework, and the business, industry and environment in which the entity operates. Specific matters for consideration may include: o Addressing whether significant assumptions are appropriate. This may be particularly challenging in this environment, for example, forecasted revenues and cash flows may be highly uncertain and the road to recovery

[13] ISA 330, *The Auditor's Responses to Assessed Risks*

Relevant Matter	Matter for Consideration
	is unclear (especially in certain industries). These assumptions may also span multiple account balances (e.g., forecasted revenues may be relevant for impairment tests and recognition of deferred tax assets). o Obtaining a management-provided sensitivity analysis, which may provide the auditor an understanding of the range of potential outcomes for alternative assumptions and whether management selected an “optimistic” or “pessimistic” scenario. Given the uncertainty because of the COVID-19 pandemic, a sensitivity analysis may be particularly important to determine the effect of changes in the significant assumptions on the accounting estimate and the impact that may have on the entity’s financial position. • Whether the significant assumptions are consistent with each other, and with those used in other accounting estimates. • When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. This may be particularly important in the current circumstances because some courses of action may be restricted by the government and the entity may not have the liquidity, or access to liquidity, to consider or pursue other courses of action.
Data (ISA 540 (Revised), paragraph 25)	• Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the applicable financial reporting framework, and the business, industry and environment in which the entity operates. For example: o Contracts are considered data under ISA 540 (Revised). In the current environment, entities may renegotiate the terms of existing contracts and arrangements. Examples include contracts with customers, compensation arrangements with employees, leases and the terms of many financial assets and liabilities. o Management may need to use different data sources because of the environment. In such circumstances, the auditor may consider the relevance and reliability of such data sources. o The accounting estimate may be dependent on data that is not readily observable or available given the effects of the pandemic. • Whether the data has been appropriately understood or interpreted by management. With respect to complex legal or contractual terms, the auditor may consider whether specialized skills or knowledge are needed to understand and interpret the contract. The auditor may also inspect the underlying contract to consider whether the terms of the contracts are consistent with management’s explanations.

As a result of the COVID-19 pandemic:

- It may be more challenging for management to understand and address estimation uncertainty by selecting an appropriate point estimate, and by developing related disclosures. This may also result in challenges for auditors as ISA 540 (Revised) requires the auditor's further audit procedures to address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to understand and address estimation uncertainty.[14] When, in the auditor's judgement, management has not taken appropriate steps to address estimation uncertainty, ISA 540 (Revised) describes the auditor's responsibilities.[15]
- There may be more instances where the size of the auditor's range is multiples of materiality for the financial statements as a whole as the estimation uncertainty is higher. Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range. In such circumstances, disclosures about estimation uncertainty also becomes more important (also see section below on the auditor's considerations in regard to disclosures).[16]

Management should assess (and auditors should evaluate) what information was known at the financial statement date to determine if adjustments to accounting estimates are necessary or whether disclosures are required. For further details on subsequent events, refer to IAASB Staff Audit Practice Alert "*Subsequent Events in the Current Evolving Environment–Audit Considerations for the Impact of COVID-19.*"

Disclosures

ISA 540 (Revised) includes requirements on disclosures in three places. Paragraph 31 addresses all disclosures related to accounting estimates, other than those related to estimation uncertainty. Paragraphs 26(b) and 29(b) address the disclosures related to estimation uncertainty.

The importance of robust disclosures about accounting estimates in the current environment cannot be emphasized enough. The disclosures will help users of the financial statements understand the nature and extent of volatility and estimation uncertainty in the relevant amounts where the variables are difficult to predict.

When the size of the auditor's range is multiples of materiality, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes.[17]

14 ISA 540 (Revised) paragraphs 26, A109–A114

15 ISA 540 (Revised) paragraph 27

16 ISA 540 (Revised) paragraph A125

17 ISA 540 (Revised) paragraph A125

IFRS 7[18] also requires qualitative and quantitative disclosures related to credit risk, liquidity risk and market risk. As part of the auditor's considerations when obtaining audit evidence about disclosures, these disclosures are largely related to the work on accounting estimates and may also need to be considered in light of the enhanced requirements of ISA 540 (Revised). For example, an entity's credit risk may have changed significantly because counterparties have failed to meet their obligations because, for example, they have been affected by government-imposed restrictions or other adverse trading conditions. Liquidity risk may change as banks may be more prudent in lending money and market risk may have changed because of fluctuations in interest rates.

ISA 540 (Revised)[19] also highlights that, in certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation. In the current environment there may be additional disclosures necessary that may not have been needed before the pandemic.

Implications for the Auditor's Report

The IAASB Staff Audit Practice Alert "*Auditor Reporting in the Current Evolving Environment Due to COVID-19*" includes guidance for auditors in considering the implications of COVID-19 on the auditor's report. Among other matters, that Staff Audit Practice Alert highlights that if the auditor's consideration of estimation uncertainty associated with an accounting estimate and its related disclosure is a matter that required significant auditor attention, this may constitute a key audit matter in accordance with ISA 701.[20] Given that the degree of estimation uncertainty, complexity and subjectivity may be higher because of the effects of the COVID-19 pandemic, the number of areas in the financial statements that involved significant auditor judgments may likely have increased.

The IAASB's Staff Audit Practice Alert on Auditor Reporting also highlights that, in accordance with ISA 706 (Revised),[21] the auditor may consider it necessary to include an emphasis of matter paragraph in the auditor's report to draw users' attention to a matter that, in the auditor's judgement, is of such importance that it is fundamental to the users' understanding of the financial statements. For example, when ISA 701 does not apply, the auditor may include an emphasis of matter paragraph to draw attention to a matter relevant to an accounting estimate (or its related disclosures) that is fundamental to the users understanding of the volatility and uncertainty within the accounting estimate.

The COVID-19 pandemic has tested the way auditors obtain audit evidence. In relation to accounting estimates, it may be more difficult to obtain sufficient appropriate audit evidence related to the data, assumptions and methods used to make the accounting estimate. If the auditor is unable to obtain sufficient appropriate audit evidence, for example because management may have used data that is not reliable and there is no other appropriate way to obtain the necessary audit evidence, the auditor shall evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with ISA 705 (Revised).[22]

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18 International Financial Reporting Standard (IFRS) 7, *Financial Instruments: Disclosures*

19 ISA 540 (Revised), paragraph A112

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

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

22 ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

Management Bias and Fraud

All accounting estimates have some degree of estimation uncertainty, which gives rise to subjectivity. The presence of subjectivity gives rise to the need for judgment by management, and therefore the susceptibility to unintentional or intentional management bias.[23] Where there is intention to mislead, management bias is fraudulent in nature.

Indicators of Management Bias

Because of the COVID-19 pandemic, the degree to which accounting estimates are affected by subjectivity may be higher as there is, for example, uncertainty about the period of the pandemic, and the nature and extent of the pandemic's impact. Therefore, the auditor's evaluation of potential indicators of management bias may be more critical than before the pandemic. When evaluating potential indicators of management bias,[24] the auditor may consider that management bias may be different than before the pandemic. For example, before the pandemic management may have been unintentionally biased to achieve a desired profit target. This may have changed in the current environment as, for example, management may be biased (unintentionally or intentionally) by the need to qualify for government support packages.

Indicators of possible management bias may also be a fraud risk factor (i.e., in the case of intentional bias), and may cause the auditor to perform different and more robust audit procedures.

Fraud

Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating such estimates, or related assumptions. For example, management may overstate future cash flows to avoid an impairment of the entity's assets. In the current environment, it is likely that auditors will need to focus on the entity's impairment calculations, in particular the inputs into those calculations, because of the increased subjectivity associated with those inputs.

Management may also be incentivized to meet certain financial or operating targets. In the current environment there is an increased possibility that some entities may breach loan covenants due to changed ratios or targets, for example, because the value of current assets relative to current liabilities has changed. Management may intentionally misrepresent the financial position so as not to breach the covenants given the impact that this may have on the entity.

The risk of a material misstatement due to fraud may also be higher because the entity's controls are not operating effectively, for example, because employees may be working remotely and the system of internal control has not been adequately adjusted for the changed working environment. If there is an increased risk of material misstatement due to fraud, the auditor will need to consider whether changes are needed and may need to perform different and more robust audit procedures.

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[23] Management bias is defined in the ISAs as: 'A lack of neutrality by management in the preparation of information.'

[24] ISA 540 (Revised), paragraph A134, includes several examples of indicators of possible management bias.

Other Resources

For further resources assembled by the IAASB's staff, including other COVID-19 Staff Audit Practice Alerts refer to the [IAASB's website](#).