

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

### Objective of the IAASB Discussion

The objective of this agenda item is to approve the issuance of draft proposed ISA 540 (Revised) for exposure.

### Introduction

1. Since the December 2016 IAASB meeting and January 2017 IAASB teleconference, the Task Force has made further changes to draft proposed ISA 540 (Revised) in response to the comments made by the IAASB, further deliberation by the Task Force on matters raised by the IAASB, and other changes to clarify and simplify the ISA. The marked draft of proposed ISA 540 (Revised) in **Agenda Item 2-B** reflects these changes. The clean version (**Agenda Item 2-C**) will be used as the basis for the IAASB’s discussion. An extract of the IAASB’s September 2016 discussions is available in Appendix 2 to this paper.
2. This paper covers the major changes proposed by the Task Force. It is organized as follows:
  - Section I: Introduction, Objective and appendices;
  - Section II: Risk Assessment;
  - Section III: Work effort;
  - Section IV: Other matters;
  - Section V: Conforming and consequential amendments; and
  - Appendix: Possible matters to address in the Explanatory Memorandum (EM).
3. The changes proposed by the Task Force are intended to improve the clarity of the requirements, provide sufficient application material to support consistent application of the requirements, and to remove redundant or unhelpful material that added complexity without providing clarity. The Task Force remains open to considering further changes to enhance the clarity, understandability, and practicality of the ISA.

### Matter for IAASB Consideration

1. Are the requirements clear, understandable, and capable of practical application?

### Section I – Introduction, Appendices, and Objective

#### *Overview of Changes*

4. The Task Force redrafted the Introduction section of ISA 540 to:
  - Introduce the factors of complexity, judgment and estimation uncertainty, given their importance to identifying, assessing and responding to risks of material misstatement (ROMM); and

- Highlight the key concepts of the ISA, including the importance of professional skepticism to the auditor’s work on accounting estimates and the risk of management bias.

The revised introduction is supported by two new appendices as described below.

5. The “key concepts” section (paragraphs 3A–4) also refers to the requirement for the auditor to perform an overall evaluation of whether the accounting estimates are reasonable, a concept that is fundamental to the ISA as noted in the objective of the standard (see further discussion below).
6. The Task Force aligned the concepts and improved the flow and terminology used in the standard. Based on the auditor’s understanding of the entity and its environment obtained by the auditor in accordance with paragraph 8, paragraph 10 requires the auditor to take the factors described above, and any other relevant factors, into account when identifying and assessing the ROMM related to an accounting estimate. Section III below describes the auditor’s response to the ROMM.

#### *Appendix 1*

7. Appendix 1 discusses different types of measurement bases and how they affect making accounting estimates. The appendix provides examples of how different bases affect the measurement of accounting estimates. The Task Force was of the view that showing the variety of measurement bases will help the auditor understand the extent of accounting estimates in the financial statements and how different measurement bases might contribute to the factors of complexity, judgment and estimation uncertainty. The IASB staff have been asked to comment on this appendix.

#### *Appendix 2*

8. Appendix 2 provides further background on the factors of complexity, the need for the use of judgment by management, and estimation uncertainty. Although these factors have not changed in substance since the last IAASB discussion, the Task Force was of the view that a further understanding of each of the factors would be helpful because of their importance to the auditor’s identification and assessment of, and response to, risks of material misstatement.

#### *Objective*

9. The Task Force proposed a change to the objective of ISA 540. In extant ISA 540, the auditor’s objective uses the term “adequate” for disclosures but “reasonable” for accounting estimates (see paragraph 6 of **Agenda Item 2-C**). The Task Force’s research showed that the view of the IAASB that led to the use of “adequate” in extant ISA 540 was due to a differing view of what was achievable for disclosures. The Task Force believes that continuing to use “adequate” may suggest that disclosures are somehow less important than the accounting estimate itself. Accordingly, the Task Force concluded that both the accounting estimate and the related disclosures should be “reasonable” in the context of the applicable financial reporting framework.
10. Some Task Force members questioned whether the term “reasonable” is a sufficiently high threshold. It was noted that the subjective nature of the word “reasonable” may not adequately promote, and could undermine, the exercise of professional skepticism. The Task Force considered several alternative approaches, before concluding that “reasonable” would be most appropriate provided that guidance was included as to its meaning. The Task Force therefore decided to explain in the key concepts section (paragraph 4) that reasonable goes beyond compliance with the requirements of the financial reporting framework and provided guidance in the application material (paragraph A1B

and A1C) regarding factors that may be relevant to the auditor's evaluation of whether the accounting estimates and related disclosures are reasonable.

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

2. The IAASB is asked for its views on:
  - (a) The introduction section, including the new appendices; and
  - (b) The changes to the objective.

#### **Section II – Risk Assessment**

11. The Task Force made changes to the risk assessment section of the ISA, particularly to enhance the requirements for obtaining an understanding of various elements relating to accounting estimates, and to better align the understanding with the requirements for identifying and responding to the risks of material misstatement. The main changes are:
  - Added requirement (paragraph 8(c)(aA)), and related application material, for the auditor to obtain an understanding of the regulatory factors relevant to accounting estimates. The Task Force was of the view that this requirement enhances the standard as obtaining an understanding of the regulatory factors may:
    - Assist the auditor in determining whether there are disclosures required in addition to the requirements of the applicable financial reporting framework;
    - Provide the auditor with an indication of areas for which there may be a potential for management bias in meeting regulatory requirements; and
    - Address conditions for the recognition, or methods for the measurement, of accounting estimates, or provide related guidance thereon.
  - Added requirement for the auditor to obtain an understanding of how management identifies and addresses the risk of management bias (paragraph 8(c)(iiiA)).
  - Replaced the term 'data and assumptions to which the accounting estimate is particularly sensitive to' with the term 'significant data and assumptions.' In the version of ISA 540 discussed with the Board in December, the notion of data and assumptions to which the accounting estimate is particularly sensitive was included in paragraph 8(c)(iv). The Task Force was of the view that the term significant data and assumptions was more concise. The term is explained in paragraph A35A.
12. The Task Force also expanded the application material related to paragraph 8. For example, application material was added to explain how inactive or illiquid markets may influence assumptions (paragraphs A35B and A35C). The Task Force further enhanced the application material related to the following requirements:
  - Obtaining an understanding of managements' method to make the accounting estimate (paragraph 8(c)(i));
  - Obtaining an understanding of the assumptions management uses to make the accounting estimate (paragraph 8(c)(ii)); and

- Obtaining an understanding of the data that management uses to make the accounting estimate (paragraph 8(c)(iiA));
  - The components of internal control as they relate to accounting estimates (paragraph 8(d)).
13. Based on the comments received during the December Board meeting, the Task Force enhanced the application material to paragraph 9 by clarifying the objective of the retrospective review and explaining when performing a retrospective review would not be useful.
14. The Task Force acknowledged the broad support for the factors that may give rise to the ROMM (that is, complexity, judgment, and estimation uncertainty) but that further clarification would make the requirements more capable of consistent application in practice. In light of this, the Task Force made changes to paragraph 10 and the associated application material (paragraphs A44F–A49C) to further explain these concepts and to show how they are to be applied in practice.

**Matter for IAASB Consideration**

3. The IAASB is asked for its views on the revisions to the risk assessment section of proposed ISA 540 (Revised) (paragraphs 8-10 of **Agenda Item 2-C**).

**Section III – Work Effort**

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

*Application of the Threshold*

16. The Task Force noted the IAASB's overall support for the approach to setting a threshold for the detailed work effort based on the level of the assessed ROMM. Accordingly, the Task Force resolved that only limited changes should be made to paragraph 13 and its application material. These changes include:
- Clarifying in the application material that when assessed ROMM is low, but not because that assessment includes an expectation that relevant controls are operating effectively, the auditor's assessment of ROMM is primarily influenced by inherent risk; and
  - Referring to both substantive procedures and tests of controls in paragraph 13(c).
17. The Task Force noted the comments at the December 2016 IAASB meeting about whether some firms' methodologies would permit them to assess ROMM as low without testing controls (in other words, the methodology may not allow for an assessment of ROMM as low, even with lower inherent risk, unless the auditor expected controls to be operating effectively and planned to test them). After further discussing this issue, the Task Force decided not to make further changes to paragraph 13, and acknowledged that changes to firm methodologies likely will be needed when ISA 540 (Revised) is issued.

18. Other changes made or considered included:

- The phrase “when applicable” was added to both paragraphs 13(b) and 13(c) in relation to the requirement to obtain audit evidence about the matters in paragraph 13A–13C. These words, together with the conditionality present in 13A–13C (i.e., the use of the word “when”) indicate that the auditor only needs to obtain audit evidence about the matters when the condition is present.
- The Task Force discussed the usage of the phrase “if the assessed risk of material misstatement is low, **but not because** that assessment includes an expectation that relevant controls are operating effectively” in paragraph 13(a) of Agenda Item 2-C. While some on the Task Force would have preferred the wording in paragraph 13(b) (“...**and that assessment**...”), the Task Force concluded that the word “but” was needed to signal that the assessment of the ROMM was not dependent, in any way, on the auditor’s expectations regarding relevant controls.

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

19. In light of the general support provided by the IAASB at the December 2016 IAASB meeting, the Task Force continued to refine and develop the “objectives-based” work effort approach as shown in paragraphs 13A–13C. The major changes to these sections are:

- *Complexity* (paragraph 13A):
  - Reorganized paragraph 13A to require the auditor to obtain sufficient appropriate audit evidence about each of the matters when complexity is identified as a reason for the assessed ROMM.
  - Rephrased the requirements in 13A(a)-(e) to better communicate the Task Force’s intentions, including requirements addressing whether the integrity of the significant data and assumptions has been maintained, and better linking this requirement to the concept of “significant data and assumptions” as used in the risk assessment section.
- *Judgment* (paragraph 13B):
  - Reorganized the requirement to provide a more logical flow, and reorganized the application material accordingly.
  - Added a new requirement about whether the significant assumptions are consistent with those used in other accounting estimates or other areas of the business.
  - Enhanced the application material on model adjustments in light of stakeholder input on the importance of appropriate management judgments when making adjustments to the output of a model.
- *Estimation Uncertainty* (paragraph 13C):
  - Revised the requirement extensively to give a more logical flow so that:
    - Paragraph 13C(a) addresses when management has taken appropriate steps to understand and address estimation uncertainty; and
    - Paragraphs 13C(b) and 13C(c) address when management has not appropriately addressed the effect of estimation uncertainty.

- Changed the focus of the requirement in 13C(c) from “narrowing” the auditor’s range (which may be seen as implying that it is satisfactory for the auditor to start with an unreasonably wide range, and only then seek to narrow it until all points within the range are reasonable) to only including in the auditor’s range amounts that are supported by the audit evidence and that the auditor has evaluated to be reasonable in the context of the applicable financial reporting framework. See also paragraph 25 below.
20. The Task Force discussed the application material regarding ranges and noted that there may be concerns about whether auditors are always capable of developing a range that is sufficiently precise as to be useful. However, the Task Force concluded that the development of a range is still an available audit strategy when the auditor concludes management has not appropriately addressed the effects of estimation uncertainty in an accounting estimate, and it is often a necessary step when the audit evidence does not support only one point estimate. Accordingly, the Task Force made only limited changes to the application material in A60C to A60M.

#### *The Stand Back Provision*

21. The Task Force made changes to paragraph 13E in response to the IAASB’s comments at the January 2017 IAASB teleconference.
22. The changes included making clear that the stand back provision only applies to those accounting estimates for which the auditor performed procedures to address the matters in paragraphs 13A-C (in other words, for those estimates for which the reasons for the assessment given to the ROMM included one or more of the factors of complexity, judgment or estimation uncertainty). This change is intended to focus the auditor’s stand back actions on those estimates with a higher risk of material misstatement, rather than for all accounting estimates.
23. Changes also were made to make the link with ISA 330 more explicit (including reference to the ROMM at the assertion level), and to include a reference to indicators of possible management bias in the stand back requirement. This is supported by revised application material to explain the link with ISA 330 and to provide an example of how the stand back provision may operate. (See paragraphs A121B–A121D).

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

24. In response to the IAASB’s comments at the January 2017 IAASB teleconference, the Task Force amended the order of the requirement in paragraph 13F so that it better aligns with extant ISA 540. The Task Force added a sentence regarding the consideration of all relevant audit evidence obtained, whether corroborative or contradictory, as requested by some Board members to make the evaluation stronger and to improve the focus on the application of professional skepticism.
25. The Task Force noted that the application material supporting this paragraph provides guidance for the auditor in evaluating whether an accounting estimate is misstated and whether the audit evidence supports an auditor’s point estimate or a range. The Task Force further discussed how the auditor would determine the amount of a misstatement when the audit evidence supports a range that does not encompass management’s point estimate, and in particular when the range is wide (see paragraph A121G). This led to discussion about whether ISA 540 should continue to permit auditors to develop ranges in response to management’s failure to adequately address the effects of estimation uncertainty. The Task Force concluded that it would be best to maintain the approach in extant ISA 540 (which permits the development of ranges), but that:

- The requirement in paragraph 13C(c) should be focused on only including in the range amounts that are supported by audit evidence and that the auditor has evaluated to be reasonable in the context of the applicable financial reporting framework; and
- The development of auditor's point estimates or ranges (including the amount of a misstatement when the audit evidence supports a range that does not encompass management's point estimate) should be addressed in the Explanatory Memorandum to the exposure draft so that stakeholders have an opportunity to comment (see Appendix).

**Matter for IAASB Consideration**

4. The IAASB is asked for its views on the paragraphs 13–13F of **Agenda Item 2-C**.

**Section IV - Other Matters**

26. In addition to the above changes, the Task Force has proposed other changes to respond to matters raised during the outreach, discussions with the IAASB or CAG, or during the Task Force's own deliberations. In brief, these include:
- (a) Management bias (paragraph 21) – In addition to specific material addressing management bias in paragraphs 13A-13C and 13E, the Task Force has also clarified in paragraph 21 that when indicators of possible bias are identified, the auditor needs to evaluate the implications for the audit.
  - (b) Written representations (paragraph 22) – The existing requirement on written representations has been supplemented by an additional requirement to consider whether representations are needed about specific accounting estimates (including with respect to the method used to make the accounting estimate).
  - (c) Communication with those charged with governance or management (paragraph 23) – This requirement has been expanded slightly to also cover communications regarding significant deficiencies in internal control. This is supported by application material (paragraph A121B).

*Effective Date*

27. The IAASB's usual practice is to set an effective date of a new ISA approximately 18–24 months after the final standard is issued. This delay allows time for firms to change their audit methodologies and for training to take place.
28. The Task Force notes that it may be desirable for ISA 540 (Revised) to be effective as soon as possible, given the effective date of IFRS 9 and requests by regulators and others to enhance ISA 540 as soon as possible. Given the extent of changes from the extant ISA, and to allow sufficient time for practitioners to make the necessary preparations, including with respect to methodologies and training, the Task Force recommends that the normal 18–24 month implementation period be maintained. The Task Force also believes that early adoption should be permitted and encouraged.

**Matter for IAASB Consideration**

5. What views does the IAASB have on the proposed effective date of ISA 540 (Revised)?

**Section V – Consequential and Conforming Amendments**

29. The Task Force made limited consequential and conforming amendments to ISA 260 (Revised),<sup>1</sup> and ISA 580,<sup>2</sup> and more significant amendments to ISA 500<sup>3</sup> with respect to external information sources. The amendments are included in **Agenda Item 2-D**.
30. The Task Force made several changes to ISA 500 since the December 2016 meeting with the goal of clarifying the Task Force's intention with respect to external information sources. The main changes are:
- Made amendments related to external information sources to paragraph 7 instead of paragraph 9 of ISA 500. The Task Force noted that paragraph 9 requires the auditor to evaluate the reliability of the information used but not the relevance. It was also noted that in some instances the auditor may not always be able to meet the detailed requirement in paragraph 9(a) of ISA 500 regarding the accuracy and completeness of the information, for example when there is no contractual relationship requiring provision of information between the external information source and the entity. The Task Force therefore concluded that the application material could be better linked to paragraph 7 of ISA 500 given that it is the overarching requirement and it refers to both the relevance and reliability of the audit evidence;
  - Included application material addressing instances when the auditor may not be able to consider the accuracy and completeness of the information received from an external information source (paragraph A33C); and
  - Broadened the application material related to external information sources by including examples that are not pricing-related.

**Matter for IAASB Consideration**

6. The IAASB is asked for its views on the consequential and conforming amendments made to ISA 260 (Revised), ISA 500, and ISA 580.

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<sup>1</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>2</sup> ISA 580, *Written Representations*

<sup>3</sup> ISA 500, *Audit Evidence*

## Appendix 1

### Listing of Possible Matters to Address in the Explanatory Memorandum

The Task Force has identified some matters that it believes would be useful to address in the Explanatory Memorandum and on which to specifically seek comments. These include:

- The clarity, understandability and ability to practically apply ISA 540 (Revised). Specifically for small and medium-sized practices, this would include whether the standard is sufficiently scalable, including whether the threshold in paragraph 13 of ISA 540 (Revised) is understandable.
- Whether the requirements and application material will support the application of professional skepticism when addressing accounting estimates.
- Whether the revised work effort is clear, including whether the guidance is clear, concise, and is sufficient to support consistent application in practice.
- Whether there is support for the approach taken to evaluating whether, and to what extent, there is a misstatement of an accounting estimate when dealing with an auditor's point estimate or range, and whether additional guidance would be helpful.
- With respect to external information sources, whether the IAASB should make the proposed conforming and consequential changes to ISA 500 or whether this issue should be addressed as part of the IAASB's future project on ISA 500.

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

7. The IAASB is asked whether there are other matters that should be addressed in the Explanatory Memorandum.

## Extract of Minutes – IAASB 2016 December Meeting

### ISA 540

Mr. Sharko and Mr. Pickeur introduced the topic by highlighting the objectives of the project to revise ISA 540 and timeline for moving the project forward. They also explained the reasons for seeking approval of the ED in March 2017 instead of December 2016.

#### INTRODUCTION

Mr. Sharko explained that the ISA 540 Task Force (ISA 540 TF) discussed the Introduction section but that further changes will be made to the application material to explain the key characteristics of accounting estimates, including the factors of complexity, judgment, and estimation uncertainty. The Board generally supported the ISA 540 TF's proposals but suggested consideration of the following:

- Explaining the interaction between ISA 315 (Revised) and ISA 540 in the Explanatory Memorandum to the ED, including the interaction between the factors of complexity, judgment and estimation uncertainty and the four factors that are introduced by the ISA 315 (Revised) Task Force in **Agenda Item 10-A**;
- Limiting the additions to the application material, as it was noted that excessive amounts of guidance can make the introduction section less clear. It was suggested that some of the introduction and related application material could be included in an Appendix to the standard; and
- Adding back the notion of management bias in the Introduction section as it helped to explain the focus of the ISA.

#### DEFINITIONS AND RISK ASSESSMENT

The Board generally noted support for the definitions and the risk assessment section but asked the ISA 540 TF to consider:

- Including the notion of estimation uncertainty in the definition of an accounting estimate;
- Broadening the reference to data in paragraph 8(c)(iA) and paragraph 8(c)(ii) beyond just external data;
- Simplifying paragraph 8, as some Board members were of the view that the current construct could be seen as complicated and long; and
- Broadening the scope of paragraph 9A and 11A by noting that the auditor should think about whether specialized skills or knowledge are needed throughout the audit rather than just specific phases of the audit. It was suggested to look at the guidance provided by the United States Public Company Accounting Oversight Board (PCAOB).

It was noted that the application material to paragraph 9 could be enhanced by clarifying the objective of the retrospective review and explaining when performing a retrospective review would not be useful. The Board also suggested deleting paragraph 10(d) and including application material that explains that the auditor may also take other factors into account in the assessment of the risk of material misstatement.

## WORK EFFORT

The majority of the Board supported a threshold to direct the auditor when the more detailed work effort requirements are mandatory as it was seen to help practitioners navigate through the standard and improve the clarity and understandability of the standard. However, the Board asked that the threshold be made as clear and understandable as possible.

The Board generally supported a requirement in ISA 540 that expands on when substantive procedures alone cannot provide sufficient appropriate audit evidence (option 1 as presented in **Agenda Item 2-A**). This was because it was seen to be responsive to concerns expressed by certain regulators that, without such a requirement, ISA 540 could be seen as lacking rigor regarding the importance of testing the operating effectiveness of controls in certain circumstances.

In addition the Board generally asked the ISA 540 TF to consider:

- Simplifying paragraph 13 and thereby enhancing the readability and understandability of the standard. The Board noted that the current requirements are comprehensive but complex.
- With respect to stand back requirement in paragraph 13D:
  - Whether the requirement should be performed for accounting estimates generally or individually;
  - Emphasizing the importance of professional skepticism in the stand back requirement;
  - Broadening the requirement so that it is based on the audit procedures performed in accordance with ISA 540 instead of just the work effort requirements; and
  - Aligning the requirement more closely with ISA 330<sup>4</sup> and ISA 570 (Revised).<sup>5</sup>

The Board supported the objective-based approach in paragraphs 13A-C as presented by the ISA 540 TF and provided several suggestions for how to enhance these paragraphs. These suggestions included making certain of the paragraphs more objective based, and clarifying and simplifying other paragraphs.

## OTHER MATTERS

The Board had mixed views on whether external information sources should be addressed by the ISA 540 TF or the Working Group that may be formed for a potential project related to Audit Evidence. The majority of the Board supported the ISA 540 TF's view that, as set out in **Agenda Item 2-D**, the ISA 540 TF should address external information sources. In making this decision, the Board noted that any changes to ISA 500 should be limited to external information sources and that the ISA 540 TF should be mindful of the risk of unintended consequences to aspects of the audit not related to accounting estimates. It was also agreed that this matter should be highlighted in the Explanatory Memorandum to be issued with the ED. The Board requested that consideration be given to broadening the application material related to external information sources by including examples that are not pricing-related as the application material presented is heavily focused on pricing services.

The Board also requested consideration of the following other matters in the agenda material:

- Including application material that provides guidance for when the auditor's range is large (such as when the auditor's range larger than performance materiality);

<sup>4</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

- Evaluating whether all the application material is needed. It was noted that some of the application material could be used in an International Auditing Practice Note (IAPN) on banking specific matters;
- Addressing the remaining matters suggested by the Professional Skepticism Working Group to enhance professional skepticism in auditing accounting estimates;
- Making changes to the requirements to improve the clarity, understandability, and conciseness as some requirements are complex and therefore may lead to confusion and implementation issues; and
- Considering whether all matters included in the project proposal and project update have been addressed.

#### IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron noted that the standard as presented takes into account suggestions made by CAG Representatives. He furthermore highlighted the importance of having a standard that is understandable and noted that the CAG was generally supportive of approving an ED in March 2017, noting that it is better to approve the ED later in order to get a high-quality standard.

#### PIOB OBSERVER REMARKS

Prof. Van Hulle reminded the Board that it was important to address the key messages it receives from stakeholders, including the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. To that end, he suggested including more requirements specifically related to models to respond to their comments.

With respect to the work effort, Prof. Van Hulle noted that this section can be perceived as being extremely complex and suggested simplifying the standard by reinforcing a principles-based approach and trying to simplify the language.

#### WAY FORWARD

The IAASB will discuss ISA 540 again at its teleconference in January, 2017 and its meeting in March 2017. The Task Force intends to present a draft ED for approval at the March 2017 IAASB meeting.

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<sup>5</sup> ISA 570 (Revised), *Going Concern*