



Agenda Item 4

Estimates

Objective

To discuss with, and obtain views from, the Auditing Standard Board about converging AU-C section 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (AU-C Section 540), with International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* (ISA 540 (Revised)), while also minimizing differences with Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) 2501, *Auditing Accounting Estimates, Including Fair Value Measurements*.

Estimates Task Force

The Estimates Task Force (Estimates TF) members are:

- Dora Burzenski (Chair)
- Doug Bennett
- Jeanne Dee
- Ilene Kassman
- Mike Lundberg
- Martin Hurden
- Laura Schuetze

Background

In 2018 the International Auditing and Assurance Standards Board (IAASB) and the PCAOB finalized new auditing standards to address the auditor's responsibilities relating to auditing accounting estimates in an audit of financial statements. The following provides a brief summary of these standards.

ISA 540 (Revised)

In October 2018 the IAASB issued ISA 540 (Revised) to address the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised), *Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and Its Environment* (ISA 315), ISA 330, *The Auditor's Response to Assessed Risks* (ISA 330), ISA 450, *Evaluation of Misstatements Identified During the Audit* (ISA 450), and ISA 500, *Audit Evidence* (ISA 500), and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias. The standard defines an accounting estimate as a monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty.

The following are the key concepts, extracted from paragraphs 2-9 of ISA 540 (Revised) (see the excerpt of paragraphs 2-9 of ISA 540 (Revised) in Issue 2 of this Issues paper for further details about these key concepts):

1. Requires a separate assessment of inherent risk
2. Refers to relevant requirements in ISA 315 and ISA 330 and provides related guidance to emphasize the importance of the auditor's decisions about controls relating to accounting estimates
3. Requires a separate assessment of control risk
4. Emphasizes that the auditor's further audit procedures, including when appropriate, tests of controls, need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level
5. Addresses professional skepticism in relation to accounting estimates
6. Requires the auditor to evaluate whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

ISA 540 (Revised) is effective for audits of financial statements for periods beginning on or after December 15, 2019.

PCAOB AS 2501

In December 2018 the PCAOB adopted a new auditing standard *Auditing Accounting Estimates, Including Fair Value Measurements, and Amendments to PCAOB Auditing Standards* (PCAOB Release No. 2018-005). This standard includes amendments to its standards for auditing accounting estimates and fair value measurements, under which three existing PCAOB standards will be replaced with a single, updated standard.

The standard is intended to strengthen and enhance the requirements for auditing accounting estimates by establishing a single standard that sets forth a uniform, risk-based approach. The standard replaces AS 2501, *Auditing Accounting Estimates*; and retitles the standard and rescinds AS 2502 *Auditing Fair Value Measurements and Disclosures*; and AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

The standard defines an accounting estimate as a measurement or recognition in the financial statements of (or a decision to not recognize) an account, disclosure, transaction, or event that generally involves subjective assumptions and measurement uncertainty. For purposes of this standard, a fair value measurement is a form of accounting estimate.

The new standard is expected to strengthen PCAOB auditing standards as follows¹:

1. Provides direction to prompt auditors to devote greater attention to addressing potential management bias in accounting estimates, as part of applying professional skepticism
2. Extends certain key requirements to other accounting estimates in significant accounts and disclosures, reflecting a more uniform approach to substantive testing for estimates
3. More explicitly integrates requirements with the risk assessment standards to focus auditors on estimates with greater risk of material misstatement
4. Makes other updates to the requirements to auditing accounting estimates to provide additional clarity and specificity
5. Provides a special topics appendix to address certain aspects unique to auditing fair values of financial instruments, including the use of pricing information from third parties such as pricing services and brokers or dealers.

The new PCAOB AS is effective for audits of fiscal years ending on or after December 15, 2020; the standard is pending SEC approval.

Other Related ASB Projects

Audit Evidence

The overall objective of the audit evidence project is to assess whether revisions of AU-C section 500, *Audit Evidence* are necessary to address the evolving nature of business. These issues include use of Emerging Technologies by both preparers and auditors, Audit Data Analytics (ADA), the application of Professional Skepticism, the expanding use of external information sources as audit evidence, and more broadly the accuracy, completeness, and reliability of such audit evidence.

In January 2018 and May 2018, the audit evidence task force provided an overview of preliminary issues identified by the evidence task force. At the October 2018 Auditing Standards Board (ASB) meeting the ASB discussed a first draft of a proposed SAS that would superseded AU-C section

¹ See page 2 of the “Executive Summary” from PCAOB Release No. 2018-005, *Auditing Accounting Estimates, Including Fair Value Measurements and Amendments to PCAOB Auditing Standards*

500. At its January 2019 ASB meeting and March 2019 ASB conference call, the ASB discussed updated drafts of the proposed audit evidence SAS. The proposed SAS also incorporates the amendments from ISA 540 (Revised) relating to *External Information Sources*.

The ASB is expected to vote to ballot this proposed SAS for exposure at the at the May 2019 ASB meeting (see ASB meeting agenda item 2).

Risk Assessment

The Risk Assessment task force has been monitoring the IAASB's project to revise ISA 315. Currently, the IAASB is considering the feedback received from the comment letters as a result of the Exposure Draft and thus, the project is in progress. The Risk Assessment Task Force's timetable to revise AU-C section 315 will reflect the timing of the IAASB's ISA 315 project.

In May 2019, the Risk Assessment Task Force will discuss with the ASB overall issues arising from the comment letters received by the IAASB in connection with the ISA 315 Exposure Draft (see agenda item 8).

Agenda Items Presented

- Item 4 — Estimates—Cover Letter and Issues Paper
- Item 4A — Estimates – Appendix to Agenda Item 4

Ms. Burzenski will refer to agenda item 4. Agenda item 4 presents ISA 540 (Revised) in a topical format so that the ASB has an opportunity to see the content from ISA 540 (Revised) in digestible sections, to facilitate discussion and agree on a way forward. The issues discussed in this agenda item contain the task force's proposed changes to ISA 540 (Revised) for the proposed SAS, based on the task force's discussions to date. The task force is not providing a mark-up of changes from extant AU-C section 540 because of the significant differences between ISA 540 (Revised) and extant AU-C section 540. Note boxes (in green) have been included throughout this agenda item to highlight task force discussions, conclusions, and whether the task force is still considering proposing changes. **After reading through this agenda item, the ASB will have had the opportunity to see (and discuss) a vast majority of the requirements and application material for the proposed SAS that will be brought to the board in July.**

Agenda item 4A contains a side-by-side comparison of ISA 540 (Revised); extant AU-C 540 and PCAOB AS 2501 and has been provided for information purposes only and will not be discussed during the meeting.

Issues for ASB Consideration

This paper contains the following issues for discussion by the ASB.

<i>Issue #</i>	<i>Title</i>	<i>Related ISA 540 (Revised) Paragraphs</i>
Issue 1	Scope of this Project	
Issue 2	Scope and objectives of the Proposed SAS	1 and 11
Issue 3	Definitions	12 and A14-A18
Issue 4	Separate Assessment of Inherent and Control Risk [Note: paragraphs A69-A70 are also discussed as part of Issue 5]	16-17 and A64-A80
Issue 5	Scalability	3 and A7, A20-A22, A63, A67-A70, A84
Issue 6	Retrospective Review	14 and A55-A60
Issue 7	Documentation	39 and A149-A152
Issue 8	Written Representations	37 and A145
Issue 9	Risk Assessment Procedures and Related Activities [Note: paragraph 14 and related application material in paragraphs A55-A60 are also discussed as part of issue 6; paragraphs A20-A22 and A63 are also discussed as part of issue 5]	13-15 and A19-A63
Issue 10	Responses to Risk of Material Misstatement [Note: paragraph A84 is also discussed as part of issue 5]	18-31 and A81-A132
Issue 11	Professional Skepticism	32 and A133-A136
Issue 12	Overall Evaluation	33-34 and A137-A138
Issue 13	Determining Whether Accounting Estimates are Reasonable	35-36 and A139-A144
Issue 14	Communication with TCWG	38 and A146-A148

Issue 1 — Scope of this Project

The Estimates TF was asked to consider revising AU-C section 540 in light of the issuance of ISA 540 (Revised) and PCAOB AS 2501. The Estimates TF considered the following:

- a. It is the ASB's strategy to converge its standards with those of the IAASB and to use the corresponding ISA as the base in developing its standards. While there has been some discussion by the Auditing Standards Board (ASB) over the past few years as to how this strategy should be implemented, there have been no decisions to deviate from the existing strategy for convergence.
- b. The ASB also considers the standards of other standard-setters and in particular, to minimize differences with the PCAOB.
- c. ISA 540 (Revised) includes requirements and guidance related to risk assessment activities. Prior to the issuance of ISA 540 (Revised), risk assessment activities related to understanding the entity (including understanding internal control) have mainly resided in ISA 315. The IAASB currently has a project to revise ISA 315; however, revisions have not been finalized and the future effective date is not yet determined. Therefore, any project the ASB would undertake to revise AU-C section 315 is in the beginning stages.
- d. It was the ASB's desire not to delay revising the estimates standard until after the revisions to AU-C section 315 are finalized, given that would significantly delay the effective date.

Accordingly, the Estimates TF has taken the approach to converge with ISA 540 (Revised) and has also considered whether there are aspects of the PCAOB standard that if included in the requirements or application material of generally accepted auditing standards (GAAS), would enhance audit quality for audits of financial statements of nonissuers in an effective and efficient manner. Through discussion and deliberations, the task force found that the requirements in ISA 540 (Revised) were sufficiently similar to, or were broader than, the requirements in PCAOB AS 2501; **therefore, the task force had very few suggested changes to the proposed SAS to reflect PCAOB wording.** The task force is still in the process of assessing appendix 1 of PCAOB AS 2501 and whether any content should be included in the proposed SAS or in other SASs, and will bring to the ASB any matters that arise from this at the July ASB meeting. (Note: See agenda item 4A, which contains a side-by-side comparison of ISA 540 (Revised); extant AU-C 540 and PCAOB AS 2501 for further information on the PCAOB AS 2501 requirements.)

The Estimates task force also discussed that the risk assessment content in ISA 540 (Revised) may be viewed as requiring the auditor to perform a "second risk assessment" related to estimates, rather than to be viewed as part of the auditor's overall risk assessment in conjunction with AU-C section 315. Some members of the Estimates task force supported moving certain risk assessment requirements from ISA 540 (Revised) (e.g., paragraphs 12-17) to AU-C section 315; however, this would cause AU-C section 315 to be revised for ISA 540 (Revised) and then revised again when AU-C 315 is revised for the IAASB's ISA 315 project (which is currently being undertaken). There was also discussion as to whether the revisions to AU-C section 540 could be postponed until ISA 315 is finalized by the IAASB; however, because the timeline for the AU-C section 315 project is behind the ASB's estimates project, the Estimates task force agreed that the proposed SAS should

be based on extant AU-C section 315. The risk assessment task force can consider whether any risk assessment requirements should be moved from the proposed SAS AU-C 540 to AU-C section 315 as they move forward with their project. **Accordingly, the task force is moving forward with converging with ISA 540 (Revised) and retaining the risk assessment requirements and guidance within the proposed SAS AU-C 540.**

Once the Estimates TF agreed to converge with ISA 540 (Revised), **the Estimates TF generally agreed with the concepts in the ISA and had few suggested changes to the wording of the requirements.** Further, the Estimates TF only proposed changes to the requirements and application material to the extent the concepts are different in the United States, or to provide clarification or reference to other sections of the proposed SAS or to other AU-C sections. This has resulted in a limited number of suggested changes from ISA 540 (Revised) for the proposed SAS. Therefore, the ASB is asked to identify any sections of the proposed requirements or application material contained in this agenda item to which they would like the task force to reconsider whether changes should be made, other than those already identified in this issues paper.

TF Note: The Estimates TF expressed concerns that ISA 540 (Revised) was heavily focused on banking and insurance estimates. The Estimates TF will consider removing or changing examples to better balance the proposed SAS.

The TF also noted that there are references to IFRS throughout ISA 540 (Revised); the TF will review such references to determine whether they should be revised to reflect U.S. GAAP.

Action Requested of the ASB

1. Does the ASB agree that the proposed SAS should converge with ISA 540 (Revised) and use ISA 540 (Revised) as a base for the proposed SAS AU-C 540?
2. Does the ASB agree that the requirements and application material in ISA 540 (Revised) related to risk assessment should be maintained in AU-C 540 (i.e., it is not necessary to suggest moving to AU-C 315), and that future consideration of placement of this material can occur with the risk assessment task force?
3. Are there aspects of PCAOB AS 2501 that the ASB believes the task for should reconsider for inclusion in the proposed SAS, or does the ASB agree that the requirements in ISA 540 (Revised) are sufficiently similar to those in PCAOB AS 2501, such that additional changes to address PCAOB AS 2501 are not necessary? If not, specifically what paragraphs from PCAOB AS 2501 do you believe need additional consideration for inclusion in the proposed SAS AU-C 540?

AU-C section 501

The Estimates TF also discussed AU-C section 501 *Audit Evidence—Specific Considerations for Selected Items* and whether the section relating to valuation of investments in securities and derivative instruments either conflicted with ISA 540 (Revised) or should be considered for movement into the proposed SAS. The Estimates TF was sensitive to the fact that the proposed SAS relates to all types of estimates and wanted to find a way to balance the valuation of investments with other types of estimates. While some members of the Estimates TF supported moving content from AU-C section 501 into the proposed SAS, other members of the Estimates TF believe the ASB could consider this as a separate project. Provided the content in AU-C section 501 does not conflict with AU-C 540, the Estimates TF believes such content can remain as a separate section of GAAS. Therefore, the Estimates TF has taken the following approach:

- a. Review AU-C section 501 to determine whether there are conflicts in the requirements and guidance between that section and ISA 540 (Revised) and if so, propose amendments to AU-C section 501.
- b. Review ISA 540 (Revised), paragraphs A126-A129, related to audit evidence and external information sources, to determine whether there are any conflicts with AU-C 501, and if so, propose amendments.
- c. Suggest that a separate project be considered to holistically review AU-C section 501 and determine whether enhancements can be made to AU-C section 501 to bring in risk assessment considerations and consider appendix 1 of PCAOB AS 2501 (and any other paragraphs from ISA 540 (Revised) that were determined need to be moved to AU-C 501).
- d. Suggest that the Audit Evidence task force consider the application material in ISA 540 (Revised) to determine whether any enhancements to AU-C section 500 need to be made to better reflect the concepts in 540.

Action Requested of the ASB

4. Does the ASB agree with the approach that the ASB is taking toward AU-C section 501, as stated in items a and b above?
5. The ASB is asked for their views on whether the ASB should consider a separate project to holistically review AU-C section 501, as stated in items c above?
6. Does the ASB agree that the Audit Evidence task force should consider ISA 540 (Revised) and determine whether any enhancements to AU-C section 500 are needed, as stated in item d above?

Issue 2 — Scope and Objectives of the Proposed SAS

Scope of the Proposed SAS

(ISA 540 (Revised) paragraph 1; extant AU-C section 540 paragraph .01; PCAOB AS 2501 paragraph 1)

Task force discussion

The Estimates TF agreed that the proposed SAS should address all accounting estimates. The Estimates TF discussed the need for the proposed SAS to call out fair value accounting estimates in particular. A majority of the Estimates TF agreed that the title to the proposed SAS **should not** call out fair value accounting estimates because that would give undue prominence to one type of estimate while there may be others that are equally or more significant. The Estimates TF recommends the following for the proposed SAS relating to referencing to fair value accounting estimates:

- the title of the proposed SAS should align with ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures” and not include a reference to fair value accounting estimates, so that it is clear that the proposed SAS addresses all estimates
- retain a reference to fair value accounting estimates in the first scope paragraph of the proposed SAS (from paragraph 1 of extant AU-C section 540) to clarify that the proposed SAS also covers fair value accounting estimates
- include in application material relating to the definition of “accounting estimates” a sentence similar to that from PCAOB 2501, to clarify that accounting estimates include fair value measurements
- further references throughout the proposed SAS to fair value accounting estimates is not necessary every time estimates are mentioned

The Estimates TF also discussed the key concepts in the proposed SAS and noted that paragraphs 2-9 of ISA 540 (Revised) contains important context about the content, structure, and scope of the ISA. The following are excerpts of those paragraphs of ISA 540 (Revised) for informational purposes, however these paragraphs will also be discussed further in other issues.

Excerpt of paragraphs 2-9 of ISA 540 (Revised)²

Nature of Accounting Estimates

2. Accounting estimates vary widely in nature and are required to be made by management when the monetary amounts cannot be directly observed. The

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measurement of these monetary amounts is subject to estimation uncertainty, which reflects inherent limitations in knowledge or data. These limitations give rise to inherent subjectivity and variation in the measurement outcomes. The process of making accounting estimates involves selecting and applying a method using assumptions and data, which requires judgment by management and can give rise to complexity in measurement. The effects of complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement. (Ref: Para. A1–A6, Appendix 1)

3. Although this ISA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by this ISA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by this ISA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. This ISA contains guidance on how the requirements of this ISA can be scaled. (Ref: Para. A7)

Key Concepts of This ISA

4. This ISA requires a separate assessment of inherent risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ISA 200,³ inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this ISA as the spectrum of inherent risk. (Ref: Para. A8– A9, A65–A66, Appendix 1)

5. This ISA refers to relevant requirements in ISA 315 (Revised) and ISA 330, and provides related guidance, to emphasize the importance of the auditor’s decisions about controls relating to accounting estimates, including decisions about whether:

- There are controls relevant to the audit, for which the auditor is required to evaluate their design and determine whether they have been implemented.
- To test the operating effectiveness of relevant controls.

6. This ISA also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates. In assessing control risk, the auditor takes into account whether the auditor’s further audit

³ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A40

procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor's assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.⁴ (Ref: Para. A10)

7. This ISA emphasizes that the auditor's further audit procedures (including, where appropriate, tests of controls) need to be responsive to the reasons for the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk.

8. The exercise of professional skepticism in relation to accounting estimates is affected by the auditor's consideration of inherent risk factors, and its importance increases when accounting estimates are subject to a greater degree of estimation uncertainty or are affected to a greater degree by complexity, subjectivity or other inherent risk factors. Similarly, the exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or fraud. (Ref: Para. A11)

9. This ISA requires the auditor to evaluate, based on the audit procedures performed and the audit evidence obtained, whether the accounting estimates and related disclosures are reasonable⁵ in the context of the applicable financial reporting framework, or are misstated. For purposes of this ISA, reasonable in the context of the applicable financial reporting framework means that the relevant requirements of the applicable financial reporting framework have been applied appropriately, including those that address: (Ref: Para. A12–A13, A139–A144)

- The making of the accounting estimate, including the selection of the method, assumptions and data in view of the nature of the accounting estimate and the facts and circumstances of the entity;
- The selection of management's point estimate; and
- The disclosures about the accounting estimate, including disclosures about how the accounting estimate was developed and that explain the nature, extent, and sources of estimation uncertainty.

Proposed SAS⁶

The following is paragraph 1 of ISA 540 (Revised) marked to reflect changes for the proposed SAS, as discussed in this Issue, as well as minor changes to conform to AU-C conventions.

Scope of This ~~ISA~~ Section

.01 This ~~section International Standard on Auditing (ISA) deals with~~addresses the auditor's responsibilities relating to accounting estimates, ~~including fair value accounting~~

⁴ 530, *Audit Sampling*, Appendix 3

⁵ See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(c)

⁶ This proposed Statement on Auditing Standards uses certain International Federation of Accountants (IFAC) copyright material, used with the permission of IFAC.

estimates and related disclosures, in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how section ISA-315 (Revised), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; ⁷ Section A-330,⁸ *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; section ISA-450,⁹ *Evaluation of Misstatements Identified During the Audit*; and section ISA-500¹⁰ *Audit Evidence* and other relevant AU-C sections ISAs are to be applied with regard to in relation to accounting estimates and related disclosures. It also includes requirements and guidance related to on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible management bias.

The following are excerpts of the scope sections of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

<i>ISA 540 (Revised)</i> ¹¹	<i>Extant AU-C 540</i>	<i>PCAOB AS 2501</i>
Scope of this ISA	Scope of This Section	Introduction
1. This International Standard on Auditing (ISA) deals with the auditor’s responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it includes requirements and guidance that refer to, or expand on, how ISA 315 (Revised), ¹² ISA 330, ¹³ ISA 450, ¹⁴ ISA 500 ¹⁵ and other relevant ISAs are to be applied in relation to accounting estimates and related disclosures. It also includes requirements and guidance on the evaluation of misstatements of accounting estimates and related disclosures, and indicators of possible	.01 This section addresses the auditor’s responsibilities relating to accounting estimates, <u>including fair value accounting estimates</u> and related disclosures, in an audit of financial statements. Specifically, it expands on how section 315, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i> ; section 330, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i> ; and other relevant AU-C sections are to be applied with regard to accounting estimates. It also includes	.01 This standard establishes requirements for auditing accounting estimates (including fair value measurements) in significant accounts and disclosures in financial statements.

⁷ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁸ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

⁹ ISA 450, *Evaluation of Misstatements Identified during the Audit*

¹⁰ ISA 500, *Audit Evidence*

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¹² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

¹³ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

¹⁴ ISA 450, *Evaluation of Misstatements Identified during the Audit*

¹⁵ ISA 500, *Audit Evidence*

<i>ISA 540 (Revised)¹¹</i>	<i>Extant AU-C 540</i>	<i>PCAOB AS 2501</i>
management bias.	requirements and guidance related to misstatements of individual accounting estimates and indicators of possible management bias.	

Action Requested of the ASB

7. Does the ASB agree with the scope of the proposed SAS and the changes proposed?

Objective of the Proposed SAS

(ISA 540 (Revised) paragraph 11; extant AU-C section 540 paragraph .06; PCAOB AS 2501 paragraph 3)

Task force discussion

The Estimates TF discussed the need to revisit the objective of the proposed SAS once the proposed SAS is fully developed to ensure any proposed changes are accurately reflected in the objective (i.e., at the July ASB meeting). The Estimates TF also discussed the PCAOB objective that specifically states the standard relates to accounting estimates in significant accounts and disclosures. The Estimates TF noted that GAAS (as well as the ISAs) do not currently have the concept of “significant accounts and disclosures¹⁶” as it exists in the PCAOB standards. In the PCAOB standards, there is a requirement to identify significant accounts and disclosures, and that identification drives the need for further audit procedures (i.e., the requirements in AU-C section 330). GAAS (and the ISAs) do not have this explicit requirement/concept, and therefore attempting to incorporate the PCAOB wording of AS 2501.03 would cause confusion and not be in alignment with GAAS. The Task Force noted that the current IAASB project to revise ISA 315 incorporates a concept similar to the PCAOB’s concept of “significant accounts and disclosures”. However, the Estimates TF was concerned about addressing significant accounts and disclosures in this standard when the revisions to ISA 315 are not finalized, especially given the wide-reaching impact that this concept has. The Estimates Task Force noted that the Risk Assessment Task Force will need to address this issue as part of their project; however, no changes are proposed at this time for the proposed SAS on 540.

¹⁶ PCAOB AS 2201.A10: An account or disclosure is a significant account or disclosure if there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.

Proposed SAS¹⁷

The following is paragraph 11 of ISA 540 (Revised) marked to reflect changes for the proposed SAS

11. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, accounting estimates and related disclosures in the financial statements are reasonable ~~in the context of the applicable financial reporting framework~~.

The following are excerpts of the objective sections of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

<i>ISA 540 (Revised)¹⁸</i>	<i>Extant AU-C 540</i>	<i>PCAOB AS 2501</i>
Objective	Objective	Objective
11. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework.	.06 The objective of the auditor is to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework <ul style="list-style-type: none"> a. accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable and b. related disclosures in the financial statements are adequate. 	3. The objective of the auditor is to obtain sufficient appropriate evidence to determine whether accounting estimates in significant accounts and disclosures are properly accounted for and disclosed in the financial statements.

Action Requested of the ASB

8. Recognizing that the Estimates TF will revisit the objective later in the project, does the ASB have any initial feedback relating to the objective or the proposed changes, or any additional changes to paragraph 11?

¹⁷ See footnote 6.

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Issue 3 — Definitions

(ISA 540 (Revised) paragraphs 12 and A14-A18; extant AU-C section 540 paragraphs .07 and .A9-.A10; PCAOB AS 2501 paragraph 2)

Task force discussion

The Estimates TF discussed the definitions used for purposes of ISA 540 (Revised). The Estimates TF agreed with the definitions as part of convergence with ISA 540 (Revised).

Proposed SAS¹⁹

The following are paragraphs 12 and A14-A18 of ISA 540 (Revised) marked to reflect changes for the proposed SAS

Definitions

12. For purposes of generally accepted auditing standards~~the ISAs~~, the following terms have the meanings attributed as follows: ~~below:~~

- a) *Accounting estimate* – A monetary amount for which the measurement, in accordance with the requirements of the applicable financial reporting framework, is subject to estimation uncertainty. (Ref: ~~par. Para.~~ A14)
- b) *Auditor's point estimate or auditor's range* – An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate. (Ref: ~~par. Para.~~ A15)
- c) *Estimation uncertainty* – Susceptibility to an inherent lack of precision in measurement. (Ref: ~~par. Para.~~ A16, ~~Appendix 1~~)
- d) *Management bias* – A lack of neutrality by management in the preparation of information. (Ref: ~~par. Para.~~ A17)
- e) *Management's point estimate* – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- f) *Outcome of an accounting estimate* – The actual monetary amount that results from the resolution of the transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: ~~par. Para.~~ A18)

Application Material

Definitions

A14. Accounting estimates are monetary amounts that may be related to classes of transactions or account balances recognized or disclosed in the financial statements. Accounting estimates also include monetary amounts included in disclosures or used to make judgments about recognition

¹⁹ See footnote 6.

or disclosure relating to a class of transactions or account balance. For purposes of this proposed SAS a fair value measurement is a form of accounting estimate.

TF Note: Last sentence included from par 2 of PCAOB AS 2501 to clarify that fair value measurements are considered estimates.

A15. An auditor's point estimate or range may be used to evaluate an accounting estimate directly (for example an impairment provision or the fair value of different types of financial instruments) or indirectly (for example an amount to be used as a significant assumption for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating a non-monetary item of data or an assumption (for example an estimated useful life of an asset).

A16. Not all accounting estimates are subject to a high degree of estimation uncertainty. ~~For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However,~~ Estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

TF Note: removed example because it may cause confusion with AU-C 501, given that AU-C 501 implies certain fair value measurements are not considered estimates (e.g., AU-C 501.A12). TF to further consider whether the second example needs to be revised or removed, based on further analysis of AU-C 501, including paragraphs A.11-A.16.

A17. Financial reporting frameworks often call for neutrality, that is, freedom from bias. Estimation uncertainty gives rise to subjectivity in making an accounting estimate. The presence of subjectivity gives rise to the need for judgment by management and the susceptibility to unintentional or intentional management bias ~~(for example, as a result of motivation to achieve a desired profit target or capital ratio).~~ The susceptibility of an accounting estimate to management bias increases with extent to which there is subjectivity in making the accounting estimate.

TF Note: TF did not think example was needed and was overly focused on management intentionally manipulating numbers.

ISA A18. Some accounting estimates by their nature do not have an outcome that is relevant for the auditor's work performed in accordance with this ISA proposed SAS. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or a liability is transferred may differ from the related accounting estimate made at the reporting date because, with the passage of time, the market participants' perceptions of value have changed.

See Agenda Item 4A “Appendix of Agenda Item 4” for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

9. Does the ASB agree with the proposed revisions to the definitions section, including the related application material?

Issue 4 — Separate Assessment of Inherent and Control Risk

(ISA 540 (Revised) paragraphs 16-17 and A64-A80; extant AU-C 540 paragraphs 10-11 and .A45-.A51)

Task force discussion

The Estimates TF discussed the requirement for a separate assessment of inherent and control risk. As discussed in Issue 1, some members of the Estimates task force supported moving certain risk assessment requirements from ISA 540 (Revised) to AU-C section 315, which would include paragraphs 16-17, because the risk assessment content in ISA 540 (Revised) may be viewed as requiring the auditor to perform a “second risk assessment.” As stated in Issue 1, the Estimates TF agreed to move forward with convergence with ISA 540 (Revised) and not to move any of the “risk assessment procedures” into AU-C section 315; therefore, the requirement for a separate assessment of inherent and control risk has been retained in this proposed SAS.

The TF also noted that while a separate assessment of inherent risk is not required by the extant standards, AU-C 315.29 requires that as part of the risk assessment, the auditor determines whether any of the risks identified are a significant risk, excluding the effects of identified controls (i.e., an assessment of inherent risk). Therefore, the auditor is already considering inherent risk for each identified risk of material misstatement.

ISA 540 (Revised) provides background information about inherent and control risk in paragraphs 4 and 6 and related application material in paragraphs A8-A9 and A65-A66, and A10. The following are excerpts of those paragraphs to provide context for, and understanding of, the assessment of inherent risk:²⁰

4. This ISA requires a separate assessment of inherent risk for purposes of assessing the risks of material misstatement at the assertion level for accounting estimates. Depending on the nature of a particular accounting estimate, the susceptibility of an assertion to a misstatement that could be material may be subject to or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, and the interrelationship among them. As explained in ISA 200,²¹

²⁰ See footnote 2.

²¹ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph A40

inherent risk is higher for some assertions and related classes of transactions, account balances and disclosures than for others. Accordingly, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale that is referred to in this ISA as the spectrum of inherent risk. (Ref: Para. A8– A9, A65–A66, Appendix 1)

6. This ISA also requires a separate assessment of control risk when assessing the risks of material misstatement at the assertion level for accounting estimates. In assessing control risk, the auditor takes into account whether the auditor’s further audit procedures contemplate planned reliance on the operating effectiveness of controls. If the auditor does not perform tests of controls, the auditor’s assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.²² (Ref: Para. A10)

[Application material]

Inherent Risk Factors (Ref: Para. 4)

A8. Inherent risk factors are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement, before consideration of controls. Appendix 1 further explains the nature of these inherent risk factors, and their inter-relationships, in the context of making accounting estimates and their presentation in the financial statements.

A9. In addition to the inherent risk factors of estimation uncertainty, complexity or subjectivity, other inherent risk factors that the auditor may consider in identifying and assessing the risks of material misstatement may include the extent to which the accounting estimate is subject to, or affected by:

- Change in the nature or circumstances of the relevant financial statement items, or requirements of the applicable financial reporting framework which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate.
- Susceptibility to misstatement due to management bias or fraud in making the accounting estimate.

Control Risk (Ref: Para. 6)

A10. An important consideration for the auditor in assessing control risk at the assertion level is the effectiveness of the design of the controls that the auditor intends to rely on and the extent to which the controls address the assessed inherent risks at the assertion level. The auditor’s evaluation that controls are effectively designed and have been implemented supports an expectation about the operating effectiveness of the controls in determining whether to test them.

....

A65. Paragraph A42 of ISA 200 states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, this ISA requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit

²² 530, *Audit Sampling*, Appendix 3

procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates in accordance with ISA 330.²³

A66. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining:

- Where inherent risk is assessed on the spectrum of inherent risk; and
- The reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.
- The interrelationships between the inherent risk factors are further explained in Appendix 1.

Proposed SAS²⁴

The following are paragraphs 16-19 and A64-A80 of ISA 540 (Revised) marked to reflect changes for the proposed SAS, considering the above discussion.

[Note: Paragraphs A68-A70 were discussed in issue 6 and have also been included in this section (shaded in grey)]

16. In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, as required by [AU-C section ISA-315 \(Revised\)](#),²⁵ the auditor ~~should shall~~ separately assess inherent risk and control risk. The auditor ~~should shall~~ take the following into account in identifying the risks of material misstatement and in assessing inherent risk: (Ref: Para. A64– A71)

- a. The degree to which the accounting estimate is subject to estimation uncertainty; and (Ref: Para. A72–A75)
- b. The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors: (Ref: Para. A76–A79)
 - (i) The selection and application of the method, assumptions and data in making the accounting estimate; or
 - (ii) The selection of management's point estimate and related disclosures for inclusion in the financial statements.

²³ ISA 330, paragraph 7(b)

²⁴ See footnote 6.

²⁵ [AU-C section ISA-315 \(Revised\)](#), paragraph ~~2625~~ and ~~2726~~

17. The auditor ~~should shall~~ determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 are, in the auditor's judgment, a significant risk.²⁶ If the auditor has determined that a significant risk exists, the auditor ~~should shall~~ obtain an understanding of the entity's controls, including control activities, relevant to that risk.²⁷ (Ref: Para. A80)

[Application Material]

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 4, 16)

A64. Identifying and assessing risks of material misstatement at the assertion level relating to accounting estimates is important for all accounting estimates, including not only those that are recognized in the financial statements, but also those that are included in the notes to the financial statements.

A65. Paragraph ~~A44A42~~ of AU-C section ISA 200 states that GAAS the ISAs do not ordinarily refer to inherent risk and control risk separately. However, this proposed SAS ISA requires a separate assessment of inherent risk and control risk to provide a basis for designing and performing further audit procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates in accordance with AU-C section ISA-330.²⁸

A66. As discussed in paragraph 4, paragraph .A42 of AU-C section 200 explains that inherent risk is higher for some assertions and related classes of transactions, account balances, and disclosures than for others. In identifying the risks of material misstatement and in assessing inherent risk, the auditor is required to take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity, or other inherent risk factors. The auditor's consideration of the inherent risk factors may also provide information to be used in determining:

TF Note: First sentence added to link to that fact that inherent risk is different for each estimate and therefore the auditor may not have to assess every estimate.

- Where inherent risk is assessed on the spectrum of inherent risk; and
- The reasons for the assessment given to the risks of material misstatement at the assertion level, and that the auditor's further audit procedures in accordance with paragraph 18 are responsive to those reasons.
- The interrelationships between the inherent risk factors are further explained in Appendix 1.

²⁶ AU-C section ISA-315 (Revised), paragraph ~~28~~27

²⁷ AU-C section ISA-315 (Revised), paragraph ~~30~~29

²⁸ AU-C section ISA 330, paragraph 7(b)

TF Note: The Estimates TF has not discussed whether the proposed SAS will, contain appendix 1. However, the TF would like direction from the ASB as to their views on this Appendix, which is located in Agenda item 4A (see Issues question 14).

A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:

- Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
- An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.

A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.

A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the

assertion level,²⁹ regardless of the degree to which the accounting estimate was subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.

A71. The auditor's assessment of control risk may be done in different ways depending on preferred audit techniques or methodologies. The control risk assessment may be expressed using qualitative categories (for example, control risk assessed as maximum, moderate, minimum) or in terms of the auditor's expectation of how effective the control(s) is in addressing the identified risk, that is, the planned reliance on the effective operation of controls. For example, if control risk is assessed as maximum, the auditor contemplates no reliance on the effective operation of controls. If control risk is assessed at less than maximum, the auditor contemplates reliance on the effective operation of controls.

Estimation Uncertainty (Ref: ~~par. Para-~~16(a))

A72. In taking into account the degree to which the accounting estimate is subject to estimation uncertainty, the auditor may consider:

- Whether the applicable financial reporting framework requires:
 - The use of a method to make the accounting estimate that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of unobservable inputs.
 - The use of assumptions that inherently have a high level of estimation uncertainty, such as assumptions with a long forecast period, assumptions that are based on data that is unobservable and are therefore difficult for management to develop, or the use of various assumptions that are interrelated.
 - Disclosures about estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data that is not readily observable.
- Whether it is possible (or practicable, insofar as permitted by the applicable financial reporting framework) for management:

²⁹ [AU-C section 315, ISA 315 \(Revised\)](#), paragraph [3234](#)

- To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount at which an insurance claim will be settled and the timing of its settlement); or
- To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A73. The size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its susceptibility to misstatement because, for example, the accounting estimate may be understated.

A74. In some circumstances, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may preclude recognition of an item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A112–A113, A143–A144).

ISA A75. In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity’s ability to continue as a going concern. [AU-C section ISA-570 \(Revised\)](#)³⁰ establishes requirements and provides guidance in such circumstances.

Complexity or Subjectivity (Ref: Para. 16(b))

The Degree to Which Complexity Affects the Selection and Application of the Method

A76. In taking into account the degree to which the selection and application of the method used in making the accounting estimate are affected by complexity, the auditor may consider:

- The need for specialized skills or knowledge by management which may indicate that the method used to make an accounting estimate is inherently complex and therefore the accounting estimate may have a greater susceptibility to material misstatement. There may be a greater susceptibility to material misstatement when management has developed a model internally and has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.
- The nature of the measurement basis required by the applicable financial reporting framework, which may result in the need for a complex method that requires multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them. For example, an expected credit loss provision may require judgments about future credit repayments and other cash flows, based on consideration of historical experience data and the

³⁰ ⁴³ [AU-C section ISA 570, \(Revised\), *The Auditor’s Consideration of an Entity’s Ability to Continue as a Going Concern*](#)

application of forward looking assumptions. Similarly, the valuation of an insurance contract liability may require judgments about future insurance contract payments to be projected based on historical experience and current and assumed future trends.

The Degree to Which Complexity Affects the Selection and Application of the Data

A77. In taking into account the degree to which the selection and application of the data used in making the accounting estimate are affected by complexity, the auditor may consider:

- The complexity of the process to derive the data, taking into account the relevance and reliability of the data source. Data from certain sources may be more reliable than from others. Also, for confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed.
- The inherent complexity in maintaining the integrity of the data. When there is a high volume of data and multiple sources of data, there may be inherent complexity in maintaining the integrity of data that is used to make an accounting estimate.
- The need to interpret complex contractual terms. For example, the determination of cash inflows or outflows arising from a commercial supplier or customer rebates may depend on very complex contractual terms that require specific experience or competence to understand or interpret.

The Degree to Which Subjectivity Affects the Selection and Application of the Method, Assumptions or Data

A78. In taking into account the degree to which the selection and application of method, assumptions or data are affected by subjectivity, the auditor may consider:

- The degree to which the applicable financial reporting framework does not specify the valuation approaches, concepts, techniques and factors to use in the estimation method.
- The uncertainty regarding the amount or timing, including the length of the forecast period. The amount and timing is a source of inherent estimation uncertainty, and gives rise to the need for management judgment in selecting a point estimate, which in turn creates an opportunity for management bias. For example, an accounting estimate that incorporates forward looking assumptions may have a high degree of subjectivity which may be susceptible to management bias.

Other Inherent Risk Factors (Ref: Para. 16(b))

A79. The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud. For example, when an accounting estimate is subject to a high degree of subjectivity, the accounting estimate is likely to be more susceptible to misstatement due to management bias or fraud and this may result in a wide range of possible measurement outcomes. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately

influenced by unintentional or intentional management bias, and that is therefore misstated. For continuing audits, indicators of possible management bias identified during the audit of preceding periods may influence the planning and risk assessment procedures in the current period.

Significant Risks (Ref: Para. 17)

ISA A80. The auditor's assessment of inherent risk, which takes into account the degree to which an accounting estimate is subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors, assists the auditor in determining whether any of the risks of material misstatement identified and assessed are a significant risk.

See Agenda Item 4A "Appendix of Agenda Item 4" for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

10. Does the ASB agree with including the requirement for a separate assessment of inherent and control risk as part of the proposed SAS?
11. Does the ASB believe that the requirements and application material are sufficient to help the auditor make sufficient judgments related to identifying and assessing the risks of material misstatement for accounting estimates?
12. Does the ASB believe that the key concepts in paragraphs 4 and 6 provide an appropriate summary of the key concept of inherent risk, and are there any suggested changes to these paragraphs?
13. Are there other suggested changes to the requirements in ISA 540 paragraphs 16-17 and related application material in A64-A80?
14. What are the ASB's initial views on maintaining Appendix 1?

Issue 5 — Scalability

(ISA 540 (Revised) paragraphs 3, A7, A20-A22, A63, A67-A70 and A84)

Task force discussion

The Estimates TF discussed whether the requirements and guidance in ISA 540 (Revised) allows the auditor to scale the requirements to the nature of the audit. The Task Force discussed whether ISA 540 (Revised) would require the auditor to obtain an understanding of *every* estimate. The task force focused their discussion on whether the ISA has an appropriate filter to help the auditor scale the requirements. As previously discussed, the Estimates TF noted that PCAOB AS 2501 uses "significant accounts and disclosures" as a filter and discussed whether AU-C 315 provides a similar filter. The Estimates TF discussed paragraph .19 of extant AU-C section 315 that requires the auditor to obtain an understanding of the information system, including the related business

processes relevant to financial reporting, including the classes of transactions in the entity's operations that are significant to the financial statements. The Estimates TF believes that this appropriately provides a filter to enable the auditor to scale certain aspects of the risk assessment to relate to what is significant to the financial statements. It should also be noted that the lead-in to the risk assessment procedures in paragraph 13 of ISA 540 (Revised) uses the phrase "... auditor shall obtain an understanding of the following matters related to the entity's accounting estimates." This language does not use the term "each accounting estimate", which also provides additional clarity that the requirements are not performed at the individual accounting estimate level.

Paragraph 3 of ISA 540 (Revised) and related application material in paragraph A7 also explain that the nature, timing, and extent of risk assessment (and further audit procedures) can be scaled based on the estimation uncertainty of the estimate, as follows:³¹

3. Although the ISA applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. The nature, timing and extent of the risk assessment and further audit procedures required by the ISA will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. For certain accounting estimates, estimation uncertainty may be very low, based on their nature, and the complexity and subjectivity involved in making them may also be very low. For such accounting estimates, the risk assessment procedures and further audit procedures required by the ISA would not be expected to be extensive. When estimation uncertainty, complexity or subjectivity are very high, such procedures would be expected to be much more extensive. The ISA contains guidance on how the requirements of the ISA can be scaled.

A7 Examples of paragraphs that include guidance on how the requirements of this ISA can be scaled include paragraphs A20–A22, A63, A67, and A84.

The following contains excerpts of paragraphs A20-A22 and A63 of ISA 540 (Revised). These paragraphs are linked to paragraph 13 and paragraph 15 of ISA 540 (Revised) which relates to the auditor's risk assessment procedures and related activities (see Issue 9.) It should also be noted that paragraph 13 of ISA 540 (Revised) states that the procedures need to be performed "to the extent necessary to provide an appropriate basis for the identification and assessment of the risks of material misstatement"; the inclusion of this language provides additional clarity that the understanding can be scaled.³²

A20. The nature, timing, and extent of the auditor's procedures to obtain the understanding of the entity and its environment, including the entity's internal control, related to the entity's accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls

³¹ See footnote 2.

³² See footnote 6.

relevant to the audit. If so, the auditor's risk assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements. ~~and simple walk-throughs of management's process for making the accounting estimate.~~

TF Note: The Estimates TF recommends removing the reference to a "walk-through" because the term "walk through" has a specific meaning in the U.S., generally relating to requirements in the PCAOB standards, that is not contemplated by this example.

A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor's risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.

A21A. A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 1918(a) and (d) of AU-C section ISA 315 (Revised). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:

- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.
- How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities

TF Note: The Estimates TF discussed including a link to AU-C 315 sooner in this section and recommended moving the guidance from paragraph A34 of ISA 540 (Revised) closer to paragraph A20 to help with the scalability of the proposed SAS. While the new proposed paragraph, A21A, was intended to specifically address concerns about the requirement in paragraph 13(h), it was viewed as providing additional clarity to applying the requirements in paragraph 13.

A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:

TF Note: The Estimates TF noted that the scalability of the estimate relates to the complexity of the estimate itself and not the size of the entity. TF to reconsider paragraphs on scalability and whether they seem to imply that the size of the entity is driving the need for scalability.

TF to consider linking or repeating the application material in paragraph A150 and A71 of ISA 540 (Revised)

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.

- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

.....

A63. Many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

The following is an excerpt of paragraphs A67-A70 which relates to the requirement in paragraph 16 that addresses identifying and assessing the risks of material misstatement.³³

A67. The reasons for the auditor's assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors. For example:

- a. Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to be subject to high estimation uncertainty and significant subjectivity in making judgments about future events or conditions. Similar considerations apply to insurance contract liabilities.
- b. An accounting estimate for an obsolescence provision for an entity with a wide range of different inventory types may require complex systems and processes, but may involve little subjectivity and the degree of estimation uncertainty may be low, depending on the nature of the inventory.
- c. Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

A68. The relevance and significance of inherent risk factors may vary from one estimate to another. Accordingly, the inherent risk factors may, either individually or in combination, affect simple accounting estimates to a lesser degree and the auditor may identify fewer risks or assess inherent risk at the lower end of the spectrum of inherent risk.

A69. Conversely, the inherent risk factors may, either individually or in combination, affect complex accounting estimates to a greater degree, and may lead the auditor to assess inherent risk at the higher end of the spectrum of inherent risk. For these accounting estimates, the auditor's consideration of the effects of the inherent risk factors is likely to directly affect the number and nature of identified

³³ See footnote 2.

risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed in responding to the assessed risks. Also, for these accounting estimates the auditor's application of professional skepticism may be particularly important.

A70. Events occurring after the date of the financial statements may provide additional information relevant to the auditor's assessment of the risks of material misstatement at the assertion level. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise the assessment of the risks of material misstatement at the assertion level,³⁴ regardless of the degree to which the accounting estimate was subject to, or affected by estimation uncertainty, complexity, subjectivity or other inherent risk factors. Events occurring after the date of the financial statements also may influence the auditor's selection of the approach to testing the accounting estimate in accordance with paragraph 18. For example, for a simple bonus accrual that is based on a straightforward percentage of compensation for selected employees, the auditor may conclude that there is relatively little complexity or subjectivity in making the accounting estimate, and therefore may assess inherent risk at the assertion level at the lower end of the spectrum of inherent risk. The payment of the bonuses subsequent to period end may provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level.

The following is an excerpt of paragraph A84 which relates to the requirement in paragraph 18 that addresses the responses to the risks of material misstatement (also see issue 10).

Scalability

A84. The nature, timing and extent of the auditor's further audit procedures are affected by, for example:

- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
- The reasons for the assessed risks of material misstatement.

Action Requested of the ASB

15. The ASB is asked for their views on the scalability of ISA 540 (Revised), including whether there are other specific actions the Task Force should take to address scalability.

³⁴ [AU-C section 315, ISA 315 \(Revised\)](#), paragraph [3231](#)

Issue 6 — Retrospective Review

(ISA 540 (Revised) paragraph 14 and A55-A60; extant AU-C 540 paragraphs .09 and .A39-.A44; PCAOB AS 2501 paragraph 64)

Task force discussion

Paragraph 14 of ISA 540 (Revised) and related application material in paragraphs A55-A60 requires the auditor to review the outcome or re-estimation of previous accounting estimates (retrospective review). The main changes to this area in ISA 540 (Revised) related to clarifying that the review can be performed over several periods or over a shorter period (such as a half-year or quarterly), and that the auditor is required to take into account the characteristics of the accounting estimates in determining the nature and extent of the retrospective review.

The Estimates TF discussed the extent of work needed to address the retrospective review and expressed concerns about whether this would call into question a prior estimate when the actual outcome could change the estimate. The Estimates TF noted that a retrospective review may not be appropriate for all estimates and recommended including an example in the application material. The Estimates TF generally agreed with the concepts in the ISA relating to retrospective review and had few suggested changes to the wording of the requirements and application material. The Estimates TF also noted that the ISA 540 (Revised) requirements relating to the retrospective review are broader than the requirements in PCAOB AS 2501, as the PCAOB standards limit the retrospective review to only those accounting estimates that have been identified to have significant risks due to fraud. However, appendix 3, “Additional Discussion of AS 2501 and Amendments” of PCAOB Release No. 2018-005 provides further clarification that they believe the PCAOB standards already accomplish the spirit of a retrospective review, as follows (excerpted from appendix 3 of PCAOB Release No. 2018-005):

A separate requirement for performing a retrospective review is not necessary in the new standard as the requirement in AS 2401 would achieve the same objective. Further, for some estimates, the outcome of the estimate may not be known within a reporting period to facilitate such a review. Similarly, requiring a review over multi-year period would not be feasible for some estimates. Obtaining an understanding of the company's process for developing an estimate would necessarily provide information about the company's ability to make the estimate. In addition, the new standard requires the auditor to evaluate whether the company has a reasonable basis for significant assumptions used in accounting estimates.

Therefore, while there are differences between the PCAOB standards and ISA 540 (Revised), the Estimates TF concluded not to differ from ISA 540 (Revised) as this would weaken the requirement and result in less clarity as to the expectations of the auditor.

Proposed SAS³⁵

³⁵ See footnote 6.

The following are paragraphs 14 and A55-A60 of ISA 540 (Revised) that address retrospective reviews, marked to reflect changes for the proposed SAS.

14. The auditor ~~should~~~~shall~~ review the outcome of previous accounting estimates, or, ~~when~~ ~~where~~ applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor ~~should~~ ~~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. A55–A60)

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 14)

A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period, or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain:

- Information regarding the effectiveness of management’s previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management’s current process
- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
- Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.
- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor’s professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period’s financial statements, or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

A57. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by AU-C section ISA-240.³⁶ As a practical matter, the auditor’s review of previous accounting estimates as a risk assessment procedure in accordance with this proposed SAS ISA may be carried out in conjunction with the review required by AU-C section ISA-240.

³⁶ ³⁷ AU-C section ISA 240, Consideration of Fraud in a Financial Statement Audit~~The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements~~, paragraph 32(b)(ii)

A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, if an entity assumed a forecasted unemployment rate in the development of an estimate, and the actual unemployment rate differed from that assumed, this does not mean the estimate was misstated. –However, such a difference may represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.³⁷ Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess control risk and may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

[TF Note: The TF recommended moving the content from paragraph A60 earlier in the discussion and to add an example of an estimate where assumptions used in the original estimation may have changed upon performance of the retrospective review, but that would not result in the estimate being considered incorrect in the previous period. TF to consider placement (e.g., move the first sentence of A60 to the end of paragraph A56).

³⁷ ³⁸ [AU-C section 560](#), Subsequent Events, paragraph 14

Action Requested of the ASB

16. The ASB is asked for their views about the retrospective review of ISA 540 (Revised), whether the application material provides sufficient guidance, and whether any additional changes are needed to the requirement or guidance.

**Issue 7 — Documentation
(ISA 540 (Revised) paragraph 39 and A149-A152; extant AU-C section 540 paragraph .22 and .A135**

Task force discussion

The Estimates task force discussed the documentation requirements and questioned how the auditor would capture the risk assessment and judgments made as part of ISA 540 (Revised). The Estimates task force also discussed the interplay with ISA 315 documentation requirements (ISA 315.32). The Estimates TF generally agreed with the concepts in the ISA relating to documentation and had few suggested changes to the wording of the requirements and application material.

Proposed SAS³⁸

The following are paragraphs 39 and A149-A152 of ISA 540 (Revised) that address documentation, marked to reflect changes for the proposed SAS

Documentation

39. The auditor ~~should~~~~shall~~ include in the audit documentation:³⁹ (Ref: Para. A149–A152)
- (a) Key elements of the auditor’s understanding of the entity and its environment, including the entity’s internal control related to the entity’s accounting estimates;
 - (b) The linkage of the auditor’s further audit procedures with the assessed risks of material misstatement at the assertion level,⁴⁰ taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;
 - (c) The auditor’s response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;
 - (d) Indicators of possible management bias related to accounting estimates, if any, and the auditor’s evaluation of the implications for the audit, as required by paragraph 32; and

³⁸ See footnote 6.

³⁹ ~~AU-C section ISA 230, Audit Documentation, paragraphs .08-.12-8-11, and .A8A6, A7 and A10~~

⁴⁰ ~~AU-C section ISA 330, paragraph 28(b)~~

(e) Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Documentation (Ref: Para. 39)

A149. [AU-C section ISA-315 \(Revised\)](#)⁴¹ and [AU-C section ISA-330](#)⁴² provide requirements and guidance on documenting the auditor's understanding of the entity, risk assessments and responses to assessed risks. This guidance is based on the requirements and guidance in [AU-C section ISA-230](#).⁴³ In the context of auditing accounting estimates, the auditor is required to prepare audit documentation about key elements of the auditor's understanding of the entity and its environment related to accounting estimates. In addition, the auditor's judgments about the assessed risks of material misstatement related to accounting estimates, and the auditor's responses, may likely be further supported by documentation of communications with those charged with governance and management.

A150. In documenting the linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, in accordance with [AU-C section ISA-330](#), this [SASISA](#) requires that the auditor take into account the reasons given to the risks of material misstatement at the assertion level. Those reasons may relate to one or more inherent risk factors or the auditor's assessment of control risk. However, the auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.

[**TF Note:** The TF recommended that the last sentence of paragraph A150 be more prominent in the proposed SAS. TF to determine placement.]

A151. The auditor also may consider documenting:

- When management's application of the method involves complex modeling, whether management's judgments have been applied consistently and, when applicable, that the design of the model meets the measurement objective of the applicable financial reporting framework.
- When the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree, the auditor's judgments in determining whether specialized skills or knowledge are required to perform the risk assessment procedures, to design and perform procedures responsive to those risks, or to evaluate the audit evidence obtained. In these circumstances, the documentation also may include how the required skills or knowledge were applied.

A152. Paragraph [.A9A7](#) of [AU-C section ISA-230](#) notes that, although there may be no single way in which the auditor's exercise of professional skepticism is documented, the audit

⁴¹ ISA 315 (Revised), paragraphs 32 and A152–A155

⁴² ISA 330, paragraphs 28 and A63

⁴³ ISA 230, paragraph 8(c)

documentation may nevertheless provide evidence of the auditor's exercise of professional skepticism. For example, in relation to accounting estimates, when the audit evidence obtained includes evidence that both corroborates and contradicts management's assertions, the documentation may include how the auditor evaluated that evidence, including the professional judgments made in forming a conclusion as to the sufficiency and appropriateness of the audit evidence obtained. Examples of other requirements in this [SASISA](#) for which documentation may provide evidence of the exercise of professional skepticism by the auditor include:

- Paragraph 13(d), regarding how the auditor has applied an understanding in developing the auditor's own expectation of the accounting estimates and related disclosures to be included in the entity's financial statements and how that expectation compares with the entity's financial statements prepared by management;
- Paragraph 18, which requires further audit procedures to be designed and performed to obtain sufficient appropriate evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory;
- Paragraphs 23(b), 24(b), 25(b) and 32, which address indicators of possible management bias; and
- Paragraph 34, which addresses the auditor's consideration of all relevant audit evidence, whether corroborative or contradictory.

See Agenda Item 4A "Appendix of Agenda Item 4" for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

17. The ASB is asked for their views about the documentation requirements and application material in ISA 540 (Revised), and whether any additional changes are needed.

**Issue 8 — Written Representations
(ISA 540 (Revised) paragraphs 37 and A145; extant AU-C 580 paragraphs .16 and .A13-.A14 and extant AU-C 540 paragraph .22)**

Task force discussion

The task force discussed that as part of the clarity project, written representations relating to estimates was included in AU-C section 580 rather than AU-C section 540. The task force agreed that the proposed SAS should continue to address written representations relating to estimates as part of AU-C section 580. Accordingly, the task force will propose amendments to AU-C section 580; however, the changes suggested are consistent with the language in ISA 540 (Revised).

Proposed SAS⁴⁴

The following are paragraphs 37 and A145 of ISA 540 (Revised) marked to reflect changes, and proposed amendments to AU-C section 580 paragraphs that address written representations, marked to reflect changes for the proposed SAS

Written Representations

~~37. The auditor shall request written representations from management⁴⁵ and, when appropriate, those charged with governance about whether the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with 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. A145)~~

Written Representations (Ref: Para. 37)

A145. Part of the auditor's audit evidence includes obtaining representations from management about whether management believes the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework. See AU-C section 580, *Written Representations*. ^{fn 25}~~Written representations about specific accounting estimates may include representations:~~

- ~~• That the significant judgments made in making the accounting estimates have taken into account all relevant information of which management is aware.~~
 - ~~• About the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates.~~
 - ~~• That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, when relevant to the accounting estimates and disclosures.~~
 - ~~• That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and are reasonable in the context of the applicable financial reporting framework.~~
 - ~~• That appropriate specialized skills or expertise has been applied in making the accounting estimates.~~
 - ~~• That no subsequent event requires adjustment to the accounting estimates and related disclosures included in the financial statements.~~

⁴⁴ See footnote 6.

⁴⁵ ISA 580, *Written Representations*

- ~~When accounting estimates are not recognized or disclosed in the financial statements, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.~~

Proposed Conforming amendments to AU-C section 580

.16 The auditor should request *written representations from management and, when appropriate, those charged with governance* to provide written representations about whether *the methods, significant assumptions and the data used in making the accounting estimates and the related disclosures are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework. The auditor should also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used.* ~~it believes significant assumptions used by it in making accounting estimates are reasonable.~~

Estimates (Ref: par. .16)

.A13 ~~Depending on the nature, materiality, and extent of estimation uncertainty, Written~~written representations about *specific* accounting estimates ~~recognized or disclosed in the financial statements~~ may include representations

- ~~about the appropriateness of the measurement processes, including related assumptions and models, used by management in determining accounting estimates in the context of the applicable financial reporting framework and the consistency in the application of the processes.~~
- *That the significant judgments made in making the accounting estimates have taken into account all relevant information of which management is aware.*
- *About the consistency and appropriateness in the selection or application of the methods, assumptions and data used by management in making the accounting estimates.*
- that the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity when relevant to the accounting estimates and disclosures.
- that disclosures related to accounting estimates, *including disclosures describing estimation uncertainty*, are complete and *are reasonable in the context of the* ~~appropriate under the applicable financial reporting framework.~~
- *That appropriate specialized skills or expertise has been applied in making the accounting estimates.*
- that no subsequent event ~~has occurred that would~~ requires adjustment to the accounting estimates and *related* disclosures included in the financial statements.
- *When accounting estimates are not recognized or disclosed in the financial statements, about the appropriateness of management's decision that the recognition or disclosure criteria of the applicable financial reporting framework have not been met.*

~~A14 For those accounting estimates not recognized or disclosed in the financial statements, written representations also may include representations about the following:~~

- ~~• The appropriateness of the basis used by management for determining that the criteria of the applicable financial reporting framework for recognition or disclosure have not been met⁴~~
- ~~• The appropriateness of the basis used by management to overcome a presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework for those accounting estimates not measured or disclosed at fair value~~

Action Requested of the ASB

18. Does the ASB agree that the requirements for written representation relating to accounting estimates should remain in AU-C section 580 rather than the proposed SAS?
19. Does the ASB agree with the proposed changes to AU-C section 580, and are there any other changes to management representations related to accounting estimates that need to be made?

**Issue 9 — Risk Assessment Procedures and Related Activities
(ISA 540 (Revised) paragraphs 13-15 and A19-A63)**

Task force discussion

The Estimates TF discussed the requirements and application material relating to risk assessment procedures and related activities. As discussed in issue 1, some members of the Estimates task force supported moving certain risk assessment from ISA 540 (Revised), including the paragraphs discussed in this Issue, to AU-C section 315. The Estimates TF recommends moving forward with converging with ISA 540 (Revised) and retaining the risk assessment requirements and guidance within AU-C 540 and therefore propose to retain this content in the proposed SAS. The Estimates TF generally agreed with the concepts in the ISA relating to risk assessment procedures and related activities and had few suggested changes to the wording of the requirements and application material.

Proposed SAS⁴⁶

The following are paragraphs 13-15 and A19-A63 of ISA 540 (Revised). This section has not yet been fully marked to reflect changes for the proposed SAS (e.g., to change examples in the application material to reflect GAAP rather than IFRS) but has been included for the ASB to read and raise any concerns regarding the concepts contained in this section.

⁴⁶ See footnote 6.

[Note: paragraph 14 and related application material in paragraphs A55-A60 related to retrospective reviews were discussed in issue 6 and have also been included in this section (shaded in grey)]

[Note: Paragraphs A20-A22 and A63 related to scalability were discussed in issue 5 and have also been included in this section (shaded in grey).]

Risk Assessment Procedures and Related Activities

13. When obtaining an understanding of the entity and its environment, including the entity's internal control, as required by AU-C section ISA-315 (Revised),⁴⁷ the auditor ~~shall~~should obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding ~~shall~~should be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.⁴⁸ (Ref: Para. A19–A22)

The Entity and Its Environment

- a. The entity's transactions and other events and conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements. (Ref: Para. A23)
- b. The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases, and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how transactions and other events or conditions are subject to, or affected by, inherent risk factors. (Ref: Para. A24–A25)
- c. Regulatory factors relevant to the entity's accounting *estimates*, including, when applicable, regulatory frameworks ~~related to prudential supervision~~. (Ref: Para. A26)
- d. The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in 13(a)–(c) above. (Ref: Para. A27)

The Entity's Internal Control

- e. The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates. (Ref: Para. A28–A30).

⁴⁷ ~~ISA 315 (Revised), paragraphs 3, 5–6, 9, 11–12, 15–17, and 20–21~~

⁴⁸ Paragraphs .05-.06 and .12-.13 of AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.

- f.* How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's specialist~~expert~~. (Ref: Para. A31)
- g.* How the entity's risk assessment process identifies and addresses risks relating to accounting estimates. (Ref: Para. A32–A33)
- h.* The entity's information system as it relates to accounting estimates, including:
 - (i) The classes of transactions, events and conditions, that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures; and (Ref: Para. A21A and A34–A35)
 - (ii) For such accounting estimates and related disclosures, how management:
 - a.* Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management: (Ref: Para. A36– A37)
 - i.* Selects or designs, and applies, the methods used, including the use of models; (Ref: Para. A38–A39)
 - ii.* Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; (Ref: Para. A40– A43); and
 - iii.* Selects the data to be used; (Ref: Para. A44)
 - b.* Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and (Ref: Para. A45)
 - c.* Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements. (Ref: Para. A46– A49)
 - i.* Control activities relevant to the audit over management's process for making accounting estimates as described in paragraph 13(h)(ii). (Ref: Para. A50–A54)
 - j.* How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

14. The auditor ~~should~~shall review the outcome of previous accounting estimates, or, ~~when~~ where applicable, their subsequent re-estimation to assist in identifying and assessing the risks of material misstatement in the current period. The auditor ~~should~~ 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. A55–A60)

15. With respect to accounting estimates, the auditor ~~shall~~should determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit

procedures to respond to those risks, or to evaluate the audit evidence obtained. (Ref: Para. A61–A63)

Risk Assessment Procedures and Related Activities

Obtaining an Understanding of the Entity and Its Environment (Ref: Para. 13)

A19. Paragraphs 11–24 of ISA 315 (Revised) require the auditor to obtain an understanding of certain matters about the entity and its environment, including the entity’s internal control. The requirements in paragraph 13 of this ISA relate more specifically to accounting estimates and build on the broader requirements in ISA 315 (Revised).

A20. The nature, timing, and extent of the auditor’s procedures to obtain the understanding of the entity and its environment, including the entity’s internal control, related to the entity’s accounting estimates, may depend, to a greater or lesser degree, on the extent to which the individual matter(s) apply in the circumstances. For example, the entity may have few transactions or other events and conditions that give rise to the need for accounting estimates, the applicable financial reporting requirements may be simple to apply, and there may be no relevant regulatory factors. Further, the accounting estimates may not require significant judgments, and the process for making the accounting estimates may be less complex. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, complexity, subjectivity, or other inherent risk factors to a lesser degree and there may be fewer controls relevant to the audit. If so, the auditor’s risk assessment procedures are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements. ~~and simple walk-throughs of management’s process for making the accounting estimate.~~

A21. By contrast, the accounting estimates may require significant judgments by management, and the process for making the accounting estimates may be complex and involve the use of complex models. In addition, the entity may have a more sophisticated information system, and more extensive controls over accounting estimates. In these circumstances, the accounting estimates may be subject to or affected by estimation uncertainty, subjectivity, complexity or other inherent risk factors to a greater degree. If so, the nature or timing of the auditor’s risk assessment procedures are likely to be different, or be more extensive, than in the circumstances in paragraph A20.

~~A21A. A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 1918(a) and (d) of AU-C section ISA-315 (Revised). In obtaining the understanding of the entity’s information system as it relates to accounting estimates, the auditor may consider:~~

- ~~- Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.~~
- ~~- How the information system addresses the completeness of accounting estimates and related~~

disclosures, in particular for accounting estimates related to liabilities

A22. The following considerations may be relevant for entities with only simple businesses, which may include many smaller entities:

- Processes relevant to accounting estimates may be uncomplicated because the business activities are simple or the required estimates may have a lesser degree of estimation uncertainty.
- Accounting estimates may be generated outside of the general and subsidiary ledgers, controls over their development may be limited, and an owner-manager may have significant influence over their determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering the risk of management bias.

The Entity and Its Environment

The entity's transactions and other events and conditions (Ref: Para. 13(a))

A23. Changes in circumstances that may give rise to the need for, or changes in, accounting estimates may include, for example, whether:

- The entity has engaged in new types of transactions;
- Terms of transactions have changed; or
- New events or conditions have occurred.

The requirements of the applicable financial reporting framework (Ref: Para. 13(b))

A24. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and, where applicable, those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice that is acceptable under the applicable financial reporting framework, not to be the most appropriate in the circumstances of the entity.⁴⁹

A25. In obtaining this understanding, the auditor may seek to understand whether:

- The applicable financial reporting framework:
 - o Prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates;
 - o Specifies certain criteria that permit or require measurement at a fair value, for

⁴⁹ ISA 260 (Revised), paragraph 16(a).

- example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability; or
- o Specifies required or suggested disclosures, including disclosures concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates; and
- Changes in the applicable financial reporting framework require changes to the entity's accounting policies relating to accounting estimates.

Regulatory factors (Ref: Para. 13(c))

A26. Obtaining an understanding of regulatory factors, if any, that are relevant to accounting estimates may assist the auditor in identifying applicable regulatory frameworks (~~for example, regulatory frameworks established by prudential supervisors in the banking or insurance industries~~) and in determining whether such regulatory framework(s):

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework;
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements; or
- Contains requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting framework, which may indicate potential risks of material misstatement. For example, some regulators may seek to influence minimum levels for expected credit loss provisions that exceed those required by the applicable financial reporting framework.

The nature of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements (Ref: Para. 13(d))

A27. Obtaining an understanding of the nature of accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements assists the auditor in understanding the measurement basis of such accounting estimates and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management makes the accounting estimates.

The Entity's Internal Control Relevant to the Audit

The nature and extent of oversight and governance (Ref: Para. 13(e))

A28. In applying [AU-C section ISA-315 \(Revised\)](#),⁵⁰ the auditor's understanding of the nature and extent of oversight and governance that the entity has in place over management's process for

⁵⁰ [AU-C section ISA-315 \(Revised\)](#), paragraph 15¹⁴

making accounting estimates may be important to the auditor's required evaluation as it relates to whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control and whether those other components are undermined by deficiencies in the control environment.

A29. The auditor may obtain an understanding of whether those charged with governance:

- Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates;
- Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework;
- Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to call into question management's actions when those actions appear to be inadequate or inappropriate;
- Oversee management's process for making the accounting estimates, including the use of models; or
- Oversee the monitoring activities undertaken by management. This may include supervision and review procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls over the accounting estimates.

[TF Note: The TF discussed adding examples to help determine how a yes or no answer may affect the audit. TF to consider adding an overall caution that he answers to these bullets could affect the audit]

A30. Obtaining an understanding of the oversight by those charged with governance may be important when there are accounting estimates that:

- Require significant judgment by management to address subjectivity;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or assumptions with complex- interrelationships;
- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or

- Involve significant assumptions.

Management's application of specialized skills or knowledge, including the use of management's specialist~~experts~~ (Ref: Para. 13(f))

A31. The auditor may consider whether the following circumstances increase the likelihood that management needs to engage a specialist~~an expert~~:⁵¹

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 fair values.⁵²
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

The entity's risk assessment process (Ref: Para. 13(g))

A32. Understanding how the entity's risk assessment process identifies and addresses risks relating to accounting estimates may assist the auditor in considering changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information system or IT environment; and
- Key personnel.

A33. Matters that the auditor may consider in obtaining an understanding of how management identified and addresses the susceptibility to misstatement due to management bias or fraud in making accounting estimates, include whether, and if so how, management:

- Pays particular attention to selecting or applying the methods, assumptions and data used in making accounting estimates.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.

⁵¹ ~~ISA 500, paragraph 8~~

⁵² See, for example, International Financial Reporting Standard (IFRS) 13, *Fair Value Measurement*. [\[update to GAAP?\]](#)

- Monitors the need for changes in the methods, significant assumptions or the data used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

The entity's information system relating to accounting estimates (Ref: Para. 13(h)(i))

~~A34. The classes of transactions, events and conditions within the scope of paragraph 13(h) are the same as the classes of transactions, events and conditions relating to accounting estimates and related disclosures that are subject to paragraphs 18(a) and (d) of ISA 315 (Revised). In obtaining the understanding of the entity's information system as it relates to accounting estimates, the auditor may consider:~~

~~Whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions.~~

~~How the information system addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities.~~

[TF Note: Paragraph A34 has been moved up to paragraph A21A – task force to determine whether to remove it from here or to retain it here and reference paragraph A20 here.]

A35. During the audit, the auditor may identify classes of transactions, events and conditions that give rise to the need for accounting estimates and related disclosures that management failed to identify. ~~AU-C section ISA-315 (Revised) addresses deals with~~ circumstances in which ~~where~~ the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment process.⁵³

Management's Identification of the Relevant Methods, Assumptions and Sources of Data (Ref: Para. 13(h)(ii)(a))

A36. If management has changed the method for making an accounting estimate, considerations may include whether the new method is, for example, more appropriate, is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment, or whether management has another valid reason.

A37. If management has not changed the method for making an accounting estimate, considerations may include whether the continued use of the previous methods, assumptions and data is appropriate in view of the current environment or circumstances.

⁵³ AU-C section ISA-315 (Revised), paragraph 17

Methods (Ref: Para. 13(h)(ii)(a)(i))

A38. The applicable financial reporting framework may prescribe the method to be used in making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method, or the required measurement basis prescribes, or allows, the use of alternative methods.

Models

A39. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. When the model itself has an increased level of complexity or subjectivity, such as an expected credit loss model or a fair value model using level 3 inputs, controls that address such complexity or subjectivity may be more likely to be identified as relevant to the audit. When complexity in relation to models is present, controls over data integrity are also more likely to be relevant to the audit. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of control activities relevant to the audit include the following:

- How management determines the relevance and accuracy of the model;
 - o The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:
 - o The model's theoretical soundness;
 - o The model's mathematical integrity; and
 - o The accuracy and completeness of the data and the appropriateness of data and assumptions used in the model.
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate in the circumstances in accordance with the requirements of the applicable financial reporting framework. When the adjustments are not appropriate, such adjustments may be indicators of possible management bias; and
- Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

Assumptions (Ref: Para. 13(h)(ii)(a)(ii))

A40. Matters that the auditor may consider in obtaining an understanding of how management selected the assumptions used in making the accounting estimates include, for example:

- The basis for management’s selection and the documentation supporting the selection of the assumption. 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 are relevant and complete.
- When applicable, how management determines that the assumptions are consistent with each other, with those used in other accounting estimates or areas of the entity’s business activities, or with other matters that are:
 - o Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset’s useful life), and whether they are consistent with the entity’s business plans and the external environment; and
 - o Outside the control of management (for example, assumptions about interest rates, mortality rates or potential judicial or regulatory actions).
- The requirements of the applicable financial reporting framework related to the disclosure of assumptions.

A41. With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgments to support them, as follows:

- a. Those that reflect what marketplace participants would use in pricing an asset or liability, developed based on market data obtained from sources independent of the reporting entity.
- b. Those that reflect the entity’s own judgments about what assumptions marketplace participants would use in pricing the asset or liability, developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

A42. Assumptions used in making an accounting estimate are referred to as significant assumptions in this [SASISA](#) if a reasonable variation in the assumption would materially affect the measurement of the accounting estimate. A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.

Inactive or illiquid markets

A43. When markets are inactive or illiquid, the auditor’s understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;
- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate in such circumstances;
- The resources to determine the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data, and the relevance thereof, from particular external information sources may vary in such circumstances.

Data (Ref: Para. 13(h)(ii)(a)(iii))

A44. Matters that the auditor may consider in obtaining an understanding of how management selects the data on which the accounting estimates are based include:

- The nature and source of the data, including information obtained from an external information source.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

How management understands and addresses estimation uncertainty (Ref: Para. 13(h)(ii)(b)–13(h)(ii)(c))

A45. Matters that may be appropriate for the auditor to consider relating to whether and how management understands the degree of estimation uncertainty include, for example:

- Whether, and if so, how management identified alternative methods, significant assumptions or sources of data that are appropriate in the context of the applicable financial reporting framework.
- Whether, and if so, how management considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the significant assumptions or the data used in making the accounting estimate.

A46. The requirements of the applicable financial reporting framework may specify the approach to selecting management's point estimate from the reasonably possible measurement outcomes. Financial reporting frameworks may recognize that the appropriate amount is one that is appropriately selected from the reasonably possible measurement outcomes and, in some cases, may indicate that the most relevant amount may be in the central part of that range.

A47. For example, with respect to fair value estimates, IFRS⁵⁴ indicates that, if multiple valuation techniques are used to measure fair value, the results (i.e., respective indications of fair value) ~~shall~~should be evaluated considering the reasonableness of the range of values indicated by those results. A fair value measurement is the point within that range that is most representative of fair value in the circumstances. In other cases, the applicable financial reporting framework may specify the use of a probability-weighted average of the reasonably possible measurement outcomes, or of the measurement amount that is most likely or that is more likely than not.

A48. The applicable financial reporting framework may prescribe disclosures or disclosure objectives related to accounting estimates, and some entities may choose to disclose additional information. These disclosures or disclosure objectives may address, for example:

- The method of estimation used, including any applicable model and the basis for its selection.
- Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
 - o Assumptions developed internally; or
 - o Data, such as interest rates, that are affected by factors outside the control of the entity.
- The effect of any changes to the method of estimation from the prior period.
- The sources of estimation uncertainty.
- Fair value information.
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

A49. In some cases, the applicable financial reporting framework may require specific disclosures regarding estimation uncertainty, for example:

- The disclosure of information about the assumptions made about the future and other major sources of estimation uncertainty that give rise to a higher likelihood or magnitude of material adjustment to the carrying amounts of assets and liabilities after the period end. Such requirements may be described using terms such as “Key Sources

⁵⁴ IFRS 13, Fair Value Measurement, paragraph 63 [\[update for GAAP?\]](#)

of Estimation Uncertainty” or “Critical Accounting Estimates.” They may relate to accounting estimates that require management’s most difficult, subjective or complex judgments. Such judgments may be more subjective and complex, and accordingly the potential for a consequential material adjustment to the carrying amounts of assets and liabilities may increase, with the number of items of data and assumptions affecting the possible future resolution of the estimation uncertainty. Information that may be disclosed includes:

- o The nature of the assumption or other source of estimation uncertainty;
 - o The sensitivity of carrying amounts to the methods and assumptions used, including the reasons for the sensitivity;
 - o The expected resolution of an uncertainty and the range of reasonably possible outcomes in respect of the carrying amounts of the assets and liabilities affected; and
 - o An explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
 - The disclosure of specific information, such as:
 - o Information regarding the significance of fair value accounting estimates to the entity’s financial position and performance; and
 - o Disclosures regarding market inactivity or illiquidity.
 - Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
 - Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk, liquidity risk and market risk.

Control Activities Relevant to the Audit Over Management’s Process for Making Accounting Estimates (Ref: Para 13(i))

A50. The auditor’s judgment in identifying controls relevant to the audit, and therefore the need to evaluate the design of those controls and determine whether they have been implemented,

relates to management’s process described in paragraph 13(h)(ii). The auditor may not identify relevant control activities in relation to all the elements of paragraph 13(h)(ii), depending on the complexity associated with the accounting estimate.

A51. As part of obtaining an understanding of the control activities relevant to the audit, the auditor may consider:

- How management determines the appropriateness of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those responsible for making the accounting estimates and those committing the entity to the related transactions, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
- The effectiveness of the design of the control activities. Generally, it may be more difficult for management to design controls that address subjectivity and estimation uncertainty in a manner that effectively prevents, or detects and corrects, material misstatements, than it is to design controls that address complexity. Controls that address subjectivity and estimation uncertainty may need to include more manual elements, which may be less reliable than automated controls as they can be more easily bypassed, ignored or overridden by management. The design effectiveness of controls addressing complexity may vary depending on the reason for, and the nature of, the complexity. For example, it may be easier to design more effective controls related to a method that is routinely used or over the integrity of data.

A52. When management makes extensive use of information technology in making an accounting estimate, controls relevant to the audit are likely to include general IT controls and application controls. Such controls may address risks related to:

- Whether the information technology system has the capability and is appropriately configured to process large volumes of data;
- Complex calculations in applying a method. When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention;
- Whether the design and calibration of models is periodically evaluated;
- The complete and accurate extraction of data regarding accounting estimates from the entity's records or from external information sources;
- Data, including the complete and accurate flow of data through the entity's information system, the appropriateness of any modification to the data used in making accounting

estimates, the maintenance of the integrity and security of the data. When using external information sources, risks related to processing or recording the data;

- Whether management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; and
- Whether there are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over journal entries.

A53. In some ~~entities industries, such as banking or insurance~~, the term governance may be used to describe activities within the control environment, monitoring of controls, and other components of internal control, as described in AU-C section ISA-315 (Revised).⁵⁵

[TF Note: The TF recommended removing references to banking and insurance. TF to continue to look at the content to determine whether references to banking and insurance should remain.]

A54. For entities with an internal audit function, its work may be particularly helpful to the auditor in obtaining an understanding of:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The aspects of the entity's information system that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 14)

A55. A review of the outcome or re-estimation of previous accounting estimates (retrospective review) assists in identifying and assessing the risks of material misstatement when previous accounting estimates have an outcome through transfer or realization of the asset or liability in the current period, or are re-estimated for the purpose of the current period. Through performing a retrospective review, the auditor may obtain:

- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain audit evidence about the likely effectiveness of management's current process
- Audit evidence of matters, such as the reasons for changes that may be required to be disclosed in the financial statements.
- Information regarding the complexity or estimation uncertainty pertaining to the accounting estimates.

⁵⁵ AU-C section ISA-315 (Revised) paragraph A78A77

- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A56. A retrospective review may provide audit evidence that supports the identification and assessment of the risks of material misstatement in the current period. Such a retrospective review may be performed for accounting estimates made for the prior period's financial statements, or may be performed over several periods or a shorter period (such as half-yearly or quarterly). In some cases, a retrospective review over several periods may be appropriate when the outcome of an accounting estimate is resolved over a longer period.

A57. A retrospective review of management judgments and assumptions related to significant accounting estimates is required by [AU-C section ISA-240](#).⁵⁶ As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this [SAS ISA](#) may be carried out in conjunction with the review required by [AU-C section ISA-240](#).

A58. Based on the auditor's previous assessment of the risks of material misstatement, for example, if inherent risk is assessed as higher for one or more risks of material misstatement, the auditor may judge that a more detailed retrospective review is required. As part of the detailed retrospective review, the auditor may pay particular attention, when practicable, to the effect of data and significant assumptions used in making the previous accounting estimates. On the other hand, for example, for accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the application of analytical procedures as risk assessment procedures is sufficient for purposes of the review.

A59. The measurement objective for fair value accounting estimates and other accounting estimates, based on current conditions at the measurement date, deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that may be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions that affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant audit evidence. In this case, audit evidence may be obtained by understanding the outcomes of assumptions (such as a cash flow projections) and understanding the effectiveness of management's prior estimation process that supports the identification and assessment of the risk of material misstatement in the current period.

A60. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. For example, if an entity assumed a forecasted unemployment rate in the development of an estimate and the actual unemployment rate differed from that assumed, does not mean the estimate was misstated. –However, such a difference may

⁵⁶ ³⁷ [AU-C section ISA 240, Consideration of Fraud in a Financial Statement Audit](#)*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

represent a misstatement if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the context of the applicable financial reporting framework.⁵⁷ Such a difference may call into question management's process for taking information into account in making the accounting estimate. As a result, the auditor may reassess control risk and may determine that more persuasive audit evidence needs to be obtained about the matter. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed in each case.

Specialized Skills or Knowledge (Ref: Para. 15)

A61. Matters that may affect the auditor's determination of whether the engagement team requires specialized skills or knowledge, include, for example:⁵⁸

- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance contract liabilities).
- The degree of estimation uncertainty.
- The complexity of the method or model used.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made.
- The procedures the auditor intends to undertake in responding to assessed risks of material misstatement.
- The need for judgment about matters not specified by the applicable financial reporting framework.
- The degree of judgment needed to select data and assumptions.
- The complexity and extent of the entity's use of information technology in making accounting estimates.

The nature, timing and extent of the involvement of individuals with specialized skills and knowledge may vary throughout the audit.

A62. The auditor may not possess the specialized skills or knowledge necessary when the matter involved is in a field other than accounting or auditing (for example, valuation skills) and may

⁵⁷ ³⁸ [AU-C section ISA 560](#), Subsequent Events, paragraph 14

⁵⁸ ³⁹ [AU-C section ISA 220](#), *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, *Audit of Financial Statements*, paragraph 1614 and [AU-C section ISA-300](#), *Planning an Audit of Financial Statements*, paragraph 8(e)

need to use an auditor's specialistexpert.⁵⁹

A63. Many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation. However, for example, for expected credit losses of a banking institution or an insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

See Agenda Item 4A "Appendix of Agenda Item 4" for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

20. The ASB is asked whether they agree with the concepts relating to risk assessment procedures for accounting estimates, and whether other changes need to be made (recognizing that the Task Force still needs to reflect certain changes in the application material).

Issue 10 — Responses to Risk of Material Misstatement

(ISA 540 (Revised) paragraphs 18-31 and A81-A132; extant AU-C 540 paragraphs 12-13; 15-17; A36-A37, A58-A59, A64-A70, A72-A74, A77-A121; PCAOB AS 2501 paragraphs .05, .07, .09-.28)

Task force discussion

The Estimates TF discussed the requirements and application material relating to responses to the risk of material misstatement. This includes the following topics:

- Responses to the assessed risk of material misstatement (ISA par 18-20)
- Obtaining audit evidence from events occurring up to the date of the auditor's report (ISA par 21)
- Testing how management made the accounting estimate (ISA par 22)
- Methods (ISA par 23)
- Significant assumptions (ISA par 24)
- Data (ISA par 25)
- Management's selection of a point estimate and related disclosures about estimation uncertainty (ISA par 26-27)
- Developing an auditor's point estimate or range (ISA Par 28-29)
- Other considerations relating to audit evidence (ISA par 30)
- Disclosures (ISA par 31)

The Estimates TF generally agreed with the concepts in the ISA relating to this topic and had few suggested changes to the wording of the requirements and application material.

⁵⁹ [AU-C section ISA-620](#), *Using the Work of an Auditor's SpecialistExpert*

Proposed SAS⁶⁰

The following are paragraphs 18-31 and A81-A132 of ISA 540 (Revised). This section has not yet been fully marked to reflect changes for the proposed SAS but has been included for the ASB to read and raise any concerns regarding the concepts contained in this section.

[Note: paragraph A84 related to scalability was discussed in issue 5 and has also been included in this section (shaded in grey).]

Responses to the Assessed Risks of Material Misstatement

18. As required by AU-C section ISA-330,⁶¹ the auditor's further audit procedures ~~shall~~should be responsive to the assessed risks of material misstatement at the assertion level,⁶² considering the reasons for the assessment given to those risks. The auditor's further audit procedures ~~shall~~should include one or more of the following approaches:

- a. Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21);
- b. Testing how management made the accounting estimate (see paragraphs 22–27); or
- c. Developing an auditor's point estimate or range (see paragraphs 28–29).

The auditor's further audit procedures ~~shall~~should take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.⁶³ The auditor ~~shall~~should design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. (Ref: Para. A81–A84)

19. As required by AU-C section ISA-330,⁶⁴ the auditor ~~shall~~should design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls, if:

- a. The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively, or
- b. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor's tests of such controls ~~shall~~should be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor ~~shall~~should obtain more persuasive audit evidence the

⁶⁰ See footnote 6.

⁶¹ ISAAU-C section 330, paragraphs 6–15 and 18

⁶² ISAAU-C section 330, paragraphs 6–7 and ~~2221~~

⁶³ ~~ISA AU-C~~ 330, paragraph 7(b)

⁶⁴ ISAAU-C 330, paragraph 8

greater the reliance the auditor places on the effectiveness of a control.⁶⁵ (Ref: Para. A85–A89)

20. For a significant risk relating to an accounting estimate, the auditor’s further audit procedures ~~shall~~should include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures ~~shall~~should include tests of details.⁶⁶ (Ref: Para. A90)

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor’s Report

21. When the auditor’s further audit procedures include obtaining audit evidence from events occurring up to the date of the auditor’s report, the auditor ~~shall~~should evaluate whether such audit evidence is sufficient and appropriate to address the risks of material misstatement relating to the accounting estimate, taking into account that changes in circumstances and other relevant conditions between the event and the measurement date may affect the relevance of such audit evidence in the context of the applicable financial reporting framework. (Ref: Para. A91–A93)

Testing How Management Made the Accounting Estimate

22. When testing how management made the accounting estimate, the auditor’s further audit procedures ~~shall~~should include procedures, designed and performed in accordance with paragraphs 23–26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to: (Ref: Para. A94)

- a. The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and
- b. How management selected the point estimate and developed related disclosures about estimation uncertainty.

Methods

23. In applying the requirements of paragraph 22, with respect to methods, the auditor’s further audit procedures ~~shall~~should address:

- a. Whether the method selected is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from the method used in prior periods are appropriate; (Ref: Para. A95, A97)
- b. Whether judgments made in selecting the method give rise to indicators of possible management bias; (Ref: Para. A96)
- c. Whether the calculations are applied in accordance with the method and are mathematically accurate;

⁶⁵ ISAAU-C 330, paragraph 9

⁶⁶ AU-C-ISA 330, paragraphs 15 and 2224

- d. When management's application of the method involves complex modelling, whether judgments have been applied consistently and whether, when applicable: (Ref: Para. A98– A100)
 - (i) The design of the model meets the measurement objective of the applicable financial reporting framework, is appropriate in the circumstances, and, if applicable, changes from the prior period's model are appropriate in the circumstances; and
 - (ii) Adjustments to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances; and
- e. Whether the integrity of the significant assumptions and the data has been maintained in applying the method. (Ref: Para. A101)

Significant Assumptions

24. In applying the requirements of paragraph 22, with respect to significant assumptions, the auditor's further audit procedures shall/should address:

- a. Whether the significant assumptions are appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; (Ref: Para. A95, A102–A103)
- b. Whether judgments made in selecting the significant assumptions give rise to indicators of possible management bias; (Ref: Para. A96)
- c. Whether the significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, based on the auditor's knowledge obtained in the audit; and (Ref: Para. A104)
- d. When applicable, whether management has the intent to carry out specific courses of action and has the ability to do so. (Ref: Para. A105)

Data

25. In applying the requirements of paragraph 22, with respect to data, the auditor's further audit procedures shall/should address:

- a. Whether the data is appropriate in the context of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate (Ref: Para. A95, A106);
- b. Whether judgments made in selecting the data give rise to indicators of possible management bias; (Ref: Para. A96)
- c. Whether the data is relevant and reliable in the circumstances; and (Ref: Para. A107)

- d. Whether the data has been appropriately understood or interpreted by management, including with respect to contractual terms. (Ref: Para. A108)

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty

26. In applying the requirements of paragraph 22, the auditor's further audit procedures ~~shall~~should address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to:

- a. Understand estimation uncertainty; and (Ref: Para. A109)
- b. Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty. (Ref: Para. A110–A114)

27. When, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor ~~shall~~should: (Ref: Para. A115–A117)

- a. Request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's response(s) in accordance with paragraph 26;
- b. If the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 28–29; and
- c. Evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with [AU-C section ISA-265](#).⁶⁷

Developing an Auditor's Point Estimate or Range

28. When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, including when required by paragraph 27(b), the auditor's further audit procedures ~~shall~~should include procedures to evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions or data, these further audit procedures ~~shall~~should be designed and performed to address the matters in paragraphs 23–25. (Ref: Para. A118–A123)

29. If the auditor develops an auditor's range, the auditor ~~shall~~should:

- a. Determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the

⁶⁷ [ISA AU-C section 265](#), *Communicating Deficiencies in Internal Control Related Matters in an Audit to Those Charged with Governance and Management*

context of the measurement objectives and other requirements of the applicable financial reporting framework; and (Ref: Para. A124–A125)

- b. Design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement relating to the disclosures in the financial statements that describe the estimation uncertainty.

Other Considerations Relating to Audit Evidence

30. In obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, irrespective of the sources of information to be used as audit evidence, the auditor ~~shall~~should comply with the relevant requirements in AU-C section ISA-500.

When using the work of a management’s ~~specialist~~expert, the requirements in paragraphs 21–29 of this SASISA may assist the auditor in evaluating the appropriateness of the ~~specialist~~expert’s work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of AU-C ISA-500. In evaluating the work of the management’s ~~expert~~specialist, the nature, timing and extent of the further audit procedures are affected by the auditor’s evaluation of the ~~expert~~specialist’s competence, capabilities and objectivity, the auditor’s understanding of the nature of the work performed by the ~~expert~~specialist, and the auditor’s familiarity with the ~~expert~~specialist’s field of expertise. (Ref: Para. A126–A132)

Disclosures Related to Accounting Estimates

31. The auditor ~~shall~~should design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate, other than those related to estimation uncertainty addressed in paragraphs 26(b) and 29(b).

[Application Material]

Responses to the Assessed Risks of Material Misstatement

The Auditor’s Further Audit Procedures (Ref: Para. 18)

A81. In designing and performing further audit procedures the auditor may use any of the three testing approaches (individually or in combination) listed in paragraph 18. For example, when several assumptions are used to make an accounting estimate, the auditor may decide to use a different testing approach for each assumption tested.

Obtaining Relevant Audit Evidence Whether Corroborative or Contradictory

A82. Audit evidence comprises both information that supports and corroborates management’s assertions, and any information that contradicts such assertions.⁶⁸ Obtaining audit evidence in an

⁶⁸ ISA AU-C section 500, paragraph A1

unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the auditor is not required to perform an exhaustive search to identify all possible sources of audit evidence.

A83. [AU-C section ISA-330](#) requires the auditor to obtain more persuasive audit evidence the higher the auditor's assessment of the risk.⁶⁹ Therefore, the consideration of the nature or quantity of the audit evidence may be more important when inherent risks relating to an accounting estimate is assessed at the higher end of the spectrum of inherent risk.

Scalability

A84. The nature, timing and extent of the auditor's further audit procedures are affected by, for example:

- The assessed risks of material misstatement, which affect the persuasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate. For example, the assessed risks of material misstatement relating to the existence or valuation assertions may be lower for a straightforward accrual for bonuses that are paid to employees shortly after period end. In this situation, it may be more practical for the auditor to obtain sufficient appropriate audit evidence by evaluating events occurring up to the date of the auditor's report, rather than through other testing approaches.
- The reasons for the assessed risks of material misstatement.

When the Auditor Intends to Rely on the Operating Effectiveness of Relevant Controls (Ref: Para: 19)

A85. Testing the operating effectiveness of relevant controls may be appropriate when inherent risk is assessed as higher on the spectrum of inherent risk, including for significant risks. This may be the case when the accounting estimate is subject to or affected by a high degree of complexity. When the accounting estimate is affected by a high degree of subjectivity, and therefore requires significant judgment by management, inherent limitations in the effectiveness of the design of controls may lead the auditor to focus more on substantive procedures than on testing the operating effectiveness of controls.

A86. In determining the nature, timing and extent of testing of the operating effectiveness of controls relating to accounting estimates, the auditor may consider factors such as:

[TF Note: The TF expressed concerns that paragraph A86 goes beyond AU-C 330. TF to continue to discuss.]

- The nature, frequency and volume of transactions;

⁶⁹ [ISA AU-C section 330](#), paragraph 7(b), [A20A19](#)

- The effectiveness of the design of the controls, including whether controls are appropriately designed to respond to the assessed inherent risk, and the strength of governance;
- The importance of particular controls to the overall control objectives and processes in place at the entity, including the sophistication of the information system to support transactions;
- The monitoring of controls and identified deficiencies in internal control;
- The nature of the risks the controls are intended to address, for example, controls related to the exercise of judgment compared with controls over supporting data;
- The competency of those involved in the control activities;
- The frequency of performance of the control activities; and
- The evidence of performance of control activities.

Substantive Procedures Alone Cannot Provide Sufficient Appropriate Audit Evidence

A87. ~~In some industries, such as the financial services industry, When~~ management makes extensive use of IT to conduct business, it. ~~It may therefore~~ be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.

[TF Note: The TF recommended removing references to industries, as extensive use of IT is not limited to a certain industry. TF to continue to assess]

A88. Circumstances when risks for which substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level may exist include:

- When controls are necessary to mitigate risks relating to the initiation, recording, processing, or reporting of information obtained from outside of the general and subsidiary ledgers.
- Information supporting one or more assertions is electronically initiated, recorded, processed, or reported. This is likely to be the case when there is a high volume of transactions or data, or a complex model is used, requiring the extensive use of information technology to ensure the accuracy and completeness of the information. A complex expected credit loss provision may be required for a financial institution or utility entity. For example, in the case of a utility entity, the data used in developing the expected credit loss provision may comprise many small balances resulting from a high volume of transactions. In these circumstances, the auditor may conclude that sufficient appropriate audit evidence cannot be obtained without testing controls around the model used to develop the expected credit loss provision.

[TF Note: The TF suggested we link to evidence standard relating to electronic evidence. TF to consider]

In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information.

A89. As part of the audit of the financial statements for certain entities (~~such as a bank or insurer~~), the auditor also may be required by law or regulation to undertake additional procedures in relation to, or to provide an assurance conclusion on, internal control. In these and other similar circumstances, the auditor may be able to use information obtained in performing such procedures as audit evidence, subject to determining whether subsequent changes have occurred that may affect its relevance to the audit.

Significant Risks (Ref: Para. 20)

A90. When the auditor's further audit procedures in response to a significant risk consist only of substantive procedures, AU-C section ISA-330⁷⁰ requires that those procedures include tests of details. Such tests of details may be designed and performed under each of the approaches described in paragraph 18 of this SASISA based on the auditor's professional judgment in the circumstances. Examples of tests of details for significant risks related to accounting estimates include:

- Examination, for example, examining contracts to corroborate terms or assumptions.
- Recalculation, for example, verifying the mathematical accuracy of a model.
- Agreeing assumptions used to supporting documentation, such as third-party published information.

Obtaining Audit Evidence from Events Occurring up to the Date of the Auditor's Report (Ref: Para. 21)

A91. In some circumstances, obtaining audit evidence from events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence to address the risks of material misstatement. For example, sale of the complete inventory of a discontinued product shortly after the period end may provide sufficient appropriate audit evidence relating to the estimate of its net realizable value at the period end. In other cases, it may be necessary to use this testing approach in connection with another approach in paragraph 18.

A92. For some accounting estimates, events occurring up to the date of the auditor's report are unlikely to provide sufficient appropriate audit evidence regarding the accounting estimate. For example, the conditions or events relating to some accounting estimates develop only over an extended period. Also, because of the measurement objective of fair value accounting estimates, information after the period-end may not reflect the events or conditions existing at the balance sheet date and therefore may not be relevant to the measurement of the fair value accounting

⁷⁰ AU-C section ISA 330, paragraph 2221

estimate.

A93. Even if the auditor decides not to undertake this testing approach in respect of specific accounting estimates, the auditor is required to comply with [AU-C section ISA-560](#). [AU-C section ISA-560](#) requires the auditor to perform audit procedures designed to obtain sufficient appropriate audit evidence that all ~~subsequent events occurring between the date of the financial statements and the date of the auditor's report~~ subsequent events that require adjustment of, or disclosure in, the financial statements have been identified⁷¹ and appropriately reflected in the financial statements in accordance with the applicable financial reporting framework.⁷² Because the measurement of many accounting estimates, other than fair value accounting estimates, usually depends on the outcome of future conditions, transactions or events, the auditor's work under [AU-C section ISA-560](#) is particularly relevant.

[TF Note: Paragraph revised to align with AU-C 560 wording.]

Testing How Management Made the Accounting Estimate (Ref. Para. 22)

A94. Testing how management made the accounting estimate may be an appropriate approach when, for example:

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is appropriate.
- The accounting estimate is based on a large population of items of a similar nature that individually are not significant.
- The applicable financial reporting framework specifies how management is expected to make the accounting estimate. For example, this may be the case for an expected credit loss provision.
- The accounting estimate is derived from the routine processing of data.

Testing how management made the accounting estimate may also be an appropriate approach when neither of the other testing approaches is practical to perform, or may be an appropriate approach in combination with one of the other testing approaches.

Changes in Methods, Significant Assumptions and the Data from Prior Periods (Ref: Para. 23(a), 24(a), 25(a))

A95. When a change from prior periods in a method, significant assumption, or the data is not based on new circumstances or new information, or when significant assumptions are inconsistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities, the auditor may need to have further discussions with management about the circumstances and, in doing so, challenge management regarding the appropriateness of the assumptions used.

⁷¹ [AU-C section ISA-560](#), paragraph .096

⁷² [AU- C section ISA-560](#), paragraph .118

Indicators of Management Bias (Ref: Para. 23(b), 24(b), 25(b))

A96. When the auditor identifies indicators of possible management bias, the auditor may need a further discussion with management and may need to reconsider whether sufficient appropriate audit evidence has been obtained that the method, assumptions and data used were appropriate and supportable in the circumstances. An example of an indicator of management bias for a particular accounting estimate may be when management has developed an appropriate range for several different assumptions, and in each case the assumption used was from the end of the range that resulted in the most favorable measurement outcome.

Methods

The selection of the method (Ref: Para. 23(a))

A97. Relevant considerations for the auditor regarding the appropriateness of the method selected in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Whether management's rationale for the method selected is appropriate;
- Whether the method is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, other available valuation concepts or techniques, regulatory requirements, and the business, industry and environment in which the entity operates;
- When management has determined that different methods result in a range of significantly different estimates, how management has investigated the reasons for these differences; and
- Whether the change is based on new circumstances or new information. When this is not the case, the change may not be reasonable or in compliance with the applicable financial reporting framework. Arbitrary changes result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias. (see also paragraphs A133–A136)

These matters are important when the applicable financial reporting framework does not prescribe the method of measurement or allows multiple methods.

Complex modelling (Ref: Para. 23(d))

A98. A model, and the related method, is more likely to be complex when:

- Understanding and applying the method, including designing the model and selecting and using appropriate data and assumptions, requires specialized skills or knowledge;
- It is difficult to obtain data needed for use in the model because there are restrictions on the availability or observability of, or access to, data; or

- It is difficult to maintain the integrity (e.g., accuracy, consistency, or completeness) of the data and assumptions in using the model due to multiple valuation attributes, multiple relationships between them, or multiple iterations of the calculation.

A99. Matters that the auditor may consider when management uses a complex model include, for example, whether:

- The model is validated prior to usage or when there has been a change to the model, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - o The model's theoretical soundness;
 - o The model's mathematical integrity;
 - o The accuracy and completeness of the model's data and assumptions; and
 - o The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.
- Management uses appropriate skills and knowledge in using the model.

A100. Management may make adjustments to the output of the model to meet the requirements of the applicable financial reporting framework. In some industries these adjustments are referred to as overlays. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.

Maintenance of integrity of significant assumptions and the data used in applying the method (Ref: Para. 23(e))

A101. Maintaining the integrity of significant assumptions and the data in applying the method refers to the maintenance of the accuracy and completeness of the data and assumptions through all stages of information processing. A failure to maintain such integrity may result in corruption of the data and assumptions and may give rise to misstatements. In this regard, relevant considerations for the auditor may include whether the data and assumptions are subject to all changes intended by management, and not subject to any unintended changes, during activities such as input, storage, retrieval, transmission or processing.

Significant Assumptions (Ref: Para. 24)

A102. Relevant considerations for the auditor regarding the appropriateness of the significant assumptions in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of changes from the prior period may include:

- Management's rationale for the selection of the assumption;

- Whether the assumption is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether a change from prior periods in selecting an assumption is based on new circumstances or new information. When it is not, the change may not be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate may give rise to material misstatements of the financial statements or may be an indicator of possible management bias (see paragraphs A133–A136).

A103. Management may evaluate alternative assumptions or outcomes of accounting estimates, which may be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there may be variation because different market participants will use different assumptions. A sensitivity analysis may lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, and including ‘pessimistic’ and ‘optimistic’ scenarios.

A104. Through the knowledge obtained in performing the audit, the auditor may become aware of or may have obtained an understanding of assumptions used in other areas of the entity’s business. Such matters may include, for example, business prospects, assumptions in strategy documents and future cash flows. Also, if the engagement partner has performed other engagements for the entity, [ISAAU-C section –315–\(Revised\)](#)⁷³ requires the engagement partner to consider whether information obtained from those other engagements is relevant to identifying risks of material misstatement. This information may also be useful to consider in addressing whether significant assumptions are consistent with each other and with those used in other accounting estimates.

A105. The appropriateness of the significant assumptions in the context of the requirements of the applicable financial reporting framework may depend on management’s intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the applicable financial reporting framework may require management to do so. The nature and extent of audit evidence to be obtained about management’s intent and ability is a matter of professional judgment. When applicable, the auditor’s procedures may include the following:

- Review of management’s history of carrying out its stated intentions.
- Inspection of written plans and other documentation, including, when applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.

⁷³ [AU-C section 315, paragraph 8.](#) [ISA 330, paragraph 7\(b\), A19](#)

- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor’s report.
- Evaluation of the entity’s ability to carry out a particular course of action given the entity’s economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the feasibility of management’s actions.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management’s intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that significant assumptions reflect those used by marketplace participants.

Data (Ref: Para. 25(a))

A106. Relevant considerations for the auditor regarding the appropriateness of the data selected for use in the context of the applicable financial reporting framework, and, if applicable, the appropriateness of the changes from the prior period may include:

- Management’s rationale for the selection of the data;
- Whether the data is appropriate in the circumstances given the nature of the accounting estimate, the requirements of the applicable financial reporting framework, and the business, industry and environment in which the entity operates; and
- Whether the change from prior periods in the sources or items of data selected or data selected, is based on new circumstances or new information. When it is not, it is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to financial statement misstatements or may be an indicator of possible management bias (see paragraphs A133–A136).

Relevance and reliability of the data (Ref: Para. 25(c))

A107. When using information produced by the entity, [AU-C section ISA-500](#) requires the auditor to evaluate whether the information is sufficiently reliable for the auditor’s purposes, including as necessary in the circumstances, to obtain audit evidence about the accuracy and completeness of the information and evaluating whether the information is sufficiently precise and detailed for the auditor’s purposes.⁷⁴

Complex legal or contractual terms (Ref: Para. 25(d))

A108. Procedures that the auditor may consider when the accounting estimate is based on complex

⁷⁴ [AU-C section ISA-500](#), paragraph 9

legal or contractual terms include:

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract;
- Inquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts to:
 - o Evaluate, the underlying business purpose for the transaction or agreement; and
 - o Consider whether the terms of the contracts are consistent with management's explanations.

Management's Selection of a Point Estimate and Related Disclosures about Estimation Uncertainty Management's steps to understand and address estimation uncertainty (Ref: Para. 26(a))

A109. Relevant considerations regarding whether management has taken appropriate steps to understand and address estimation uncertainty may include whether management has:

- a. Understood the estimation uncertainty, through identifying the sources, and assessing the degree of inherent variability in the measurement outcomes and the resulting range of reasonably possible measurement outcomes;
- b. Identified the degree to which, in the measurement process, complexity or subjectivity affect the risk of material misstatement, and addressed the resulting potential for misstatement through applying:
 - (i) Appropriate skills and knowledge in making accounting estimates; and
 - (ii) Professional judgment, including by identifying and addressing susceptibility to management bias; and
- c. Addressed estimation uncertainty through appropriately selecting management's point estimate and related disclosures that describe the estimation uncertainty.

The selection of management's point estimate and related disclosures of estimation uncertainty (Ref: Para. 26(b))

A110. Matters that may be relevant regarding the selection of management's point estimate and the development of related disclosures about estimation uncertainty include whether:

- The methods and data used were selected appropriately, including when alternative methods for making the accounting estimate and alternative sources of data were available.
- Valuation attributes used were appropriate and complete.

- The assumptions used were selected from a range of reasonably possible amounts and were supported by appropriate data that is relevant and reliable.
- The data used was appropriate, relevant and reliable, and the integrity of that data was maintained.
- The calculations were applied in accordance with the method and were mathematically accurate.
- Management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
- The related disclosures appropriately describe the amount as an estimate and explain the nature and limitations of the estimation process, including the variability of the reasonably possible measurement outcomes.

A111. Relevant considerations for the auditor regarding the appropriateness of management's point estimate, may include:

- When the requirements of the applicable financial reporting framework prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribes a specific measurement method, whether management has followed the requirements of the applicable financial reporting framework.
- When the applicable financial reporting framework has not specified how to select an amount from reasonably possible measurement outcomes, whether management has exercised judgment, taking into account the requirements of the applicable financial reporting framework.

A112. Relevant considerations for the auditor regarding management's disclosures about estimation uncertainty include the requirements of the applicable financial reporting framework, which may require disclosures:

- That describe the amount as an estimate and explain the nature and limitations of the process for making it, including the variability in reasonably possible measurement outcomes. The framework also may require additional disclosures to meet a disclosure objective.⁷⁵
- About significant accounting policies related to accounting estimates. Depending on the circumstances, relevant accounting policies may include matters such as the specific principles, bases, conventions, rules and practices applied in preparing and presenting accounting estimates in the financial statements.

⁷⁵ ⁵¹ IFRS 13, *Fair Value Measurement*, paragraph 92 [\[update for GAAP?\]](#)

- About significant or critical judgments (for example, those that had the most significant effect on the amounts recognized in the financial statements) as well as significant forward- looking assumptions or other sources of estimation uncertainty.

In certain circumstances, additional disclosures beyond those explicitly required by the financial reporting framework may be needed in order to achieve fair presentation, or in the case of a compliance framework, for the financial statements not to be misleading.

A113. The greater the degree to which an accounting estimate is subject to estimation uncertainty, the more likely the risks of material misstatement will be assessed as higher and therefore the more persuasive the audit evidence needs to be to determine, in accordance with paragraph 35, whether management's point estimate and related disclosures about estimation uncertainty are reasonable in the context of the applicable financial reporting framework, or are misstated.

A114. 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, then this may constitute a key audit matter.⁷⁶

When Management Has Not Taken Appropriate Steps to Understand and Address Estimation Uncertainty (Ref: Para. 27)

A115. When the auditor determines that management has not taken appropriate steps to understand and address estimation uncertainty, additional procedures that the auditor may request management to perform to understand estimation uncertainty may include, for example, consideration of alternative assumptions or the performance of a sensitivity analysis.

A116. In considering whether it is practicable to develop a point estimate or range, matters the auditor may need to take into account include whether the auditor could do so without compromising independence requirements. This may include relevant ethical requirements that address prohibitions on assuming management responsibilities.

A117. If, after considering management's response, the auditor determines that it is not practicable to develop an auditor's point estimate or range, the auditor is required to evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with paragraph 34.

Developing an Auditor's Point Estimate or Using an Auditor's Range (Ref: Para. 28–29)

A118. Developing an auditor's point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty may be an appropriate approach when, for example:

[TF Note: The TF noted that the last sentence of paragraph 28 requires that, regardless of whether the auditor uses management's or the auditor's own methods, assumptions, or data, the further audit procedures need to address the matters in paragraphs 23-25. Paragraph 22, which is relevant

⁷⁶ [AU-C section 45A-701](#), *Communicating Key Audit Matters in the Independent Auditor's Report*

when testing how management made the accounting estimate, requires that the procedures in Paragraphs 23-25 be performed. The Task Force recommended clarifying that although the matters in paragraphs 23-25 are relevant when developing an auditor's point estimate or range to evaluate management's point estimate, this does not mean that the auditor is required to test management's process. TF to consider whether additional clarifying guidance is necessary.]

- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is not expected to be effective.
- The entity's controls within and over management's process for making accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report have not been properly taken into account, when it is appropriate for management to do so, and such events or transactions appear to contradict management's point estimate.
- There are appropriate alternative assumptions or sources of relevant data that can be used in developing an auditor's point estimate or a range.
- Management has not taken appropriate steps to understand or address the estimation uncertainty (see paragraph 27).

A119. The decision to develop a point estimate or range also may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value, or the most likely outcome).

A120. The auditor's decision as to whether to develop a point estimate rather than a range may depend on the nature of the estimate and the auditor's judgment in the circumstances. For example, the nature of the estimate may be such that there is expected to be less variability in the reasonably possible outcomes. In these circumstances, developing a point estimate may be an effective approach, particularly when it can be developed with a higher degree of precision.

A121. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a different model than the one used by management, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor- developed model.
- Using management's model but developing alternative assumptions or data sources to those used by management.
- Using the auditor's own method but developing alternative assumptions to those used by management.

- Employing or engaging a person with specialized expertise to develop or execute a model, or to provide relevant assumptions.
- Consideration of other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A122. The auditor also may develop a point estimate or range for only part of the accounting estimate (for example, for a particular assumption, or when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).

A123. When using the auditor's own methods, assumptions or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions or data. For example, if the auditor uses the auditor's own assumptions in developing a range to evaluate the reasonableness of management's point estimate, the auditor may also develop a view about whether management's judgments in selecting the significant assumptions used in making the accounting estimate give rise to indicators of possible management bias.

A124. The requirement in paragraph 29(a) for the auditor to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.

A125. The size of the auditor's range may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures. This situation is more likely to arise in circumstances when the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, where a high degree of estimation uncertainty is more typical and there may be specific requirements in the applicable financial reporting framework in that regard. Based on the procedures performed and audit evidence obtained in accordance with the requirements of this [SASISA](#), the auditor may conclude that a range that is multiples of materiality is, in the auditor's judgment, appropriate in the circumstances. When this is the case, 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. Paragraphs A139–A144 include additional considerations that may be relevant in these circumstances.

Other Considerations Relating to Audit Evidence (Ref: Para. 30)

A126. Information to be used as audit evidence, regarding risks of material misstatement relating to accounting estimates, may have been produced by the entity, prepared using the work of a management's [expertspecialist](#), or provided by an external information source.

External Information Sources

[TF Note: This section will need to align with the Evidence project (agenda item 2) to revise AU-C section 500. The Evidence project picks up ISA content relating to external information sources. In addition, the TF will need to assess the interplay of paragraphs A127-A128 to AU-C section 501 and possible consideration of appendix 1 of PCAOB AS 2501.]

A127. As explained in ~~ISA~~AU-C section -500,⁷⁷ the reliability of information from an external information source is influenced by its source, its nature, and the circumstances under which it is obtained. Consequently, the nature and extent of the auditor's further audit procedures to consider the reliability of the information used in making an accounting estimate may vary depending on the nature of these factors. For example:

- When market or industry data, prices, or pricing related data, are obtained from a single external information source, specializing in such information, the auditor may seek a price from an alternative independent source with which to compare.
- When market or industry data, prices, or pricing related data, are obtained from multiple independent external information sources and points to consensus across those sources, the auditor may need to obtain less evidence about the reliability of the data from an individual source.
- When information obtained from multiple information sources points to divergent market views the auditor may seek to understand the reasons for the diversity in views. The diversity may result from the use of different methods, assumptions, or data. For example, one source may be using current prices and another source using future prices. When the diversity relates to estimation uncertainty, the auditor is required by paragraph 26(b) to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, the disclosures in the financial statements that describe the estimation uncertainty are reasonable. In such cases professional judgment is also important in considering information about the methods, assumptions or data applied.
- When information obtained from an external information source has been developed by that source using its own model(s). Paragraph A33F of ISA 500 provides relevant guidance.

A128. For fair value accounting estimates, additional considerations of the relevance and reliability of information obtained from external information sources may include:

- a. Whether fair values are based on trades of the same instrument or active market quotations;
- b. When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable;
- c. When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed

⁷⁷ AU-C ISA section 500, Paragraph A32A34

and used represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and

- d. When the fair value measurement is based on a broker quote, whether the broker quote:
- (i) Is from a market maker who transacts in the same type of financial instrument;
 - (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and
 - (iii) Reflects market conditions as of the date of the financial statements, when required by the applicable financial reporting framework.

A129. When information from an external information source is used as audit evidence, a relevant consideration for the auditor may be whether information can be obtained, or whether the information is sufficiently detailed, to understand the methods, assumptions and other data used by the external information source. This may be limited in some respects and consequently influence the auditor's consideration of the nature, timing and extent of procedures to perform. For example, pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. Paragraph A33Ga of ISA 500 provides guidance with respect to restrictions placed by the external information source on the provision of supporting information.

Management's ExpertSpecialist

A130. Assumptions relating to accounting estimates that are made or identified by a management's expertspecialist become management's assumptions when used by management in making an accounting estimate. Accordingly, the auditor applies the relevant requirements in this SASISA to those assumptions.

A131. If the work of a management's expertspecialist involves the use of methods or sources of data relating to accounting estimates, or developing or providing findings or conclusions relating to a point estimate or related disclosures for inclusion in the financial statements, the requirements in paragraphs 21–29 of this ISA-SAS may assist the auditor in applying paragraph 8(c) of ISAAU-C section -500.

Service Organizations

A132. ISAAU-C section -402⁷⁸ deals with the auditor's understanding of the services provided by a service organization, including internal control, as well as the auditor's responses to assessed risks of material misstatement. When the entity uses the services of a service organization in making accounting estimates, the requirements and guidance in ISAAU-C section -402 may

⁷⁸ AU-C section ~~ISA~~402, *Audit Considerations Relating to an Entity Using a Service Organization*

therefore assist the auditor is applying the requirements of this proposed ISASAS.

See Agenda Item 4A “Appendix of Agenda Item 4” for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

21. The ASB is asked whether they agree with the concepts relating to the responses to the risk of material misstatement for accounting estimates, and whether other changes need to be made (recognizing that the Task Force still needs to reflect certain changes in the application material).

Issue 11 — Professional Skepticism

(ISA 540 (Revised) paragraphs 32 and A133-A136; extant AU-C section 540 paragraphs .21 and .A133-.A134; PCAOB AS 2501 paragraph 31)

Task Force Discussion

The Estimates TF agreed with the concepts in ISA 540 (Revised) relating to indicators of management bias. The Estimates TF considered the requirements in paragraph 31 of PCAOB AS 2501 relating to indicators of possible management bias and concluded that the PCAOB requirements were sufficiently similar with ISA 540 (Revised) requirements and application material and therefore have not proposed any changes to the ISA 540 (Revised) content relating to the PCAOB content. The task force supports convergence with ISA 540 (Revised).

Excerpt from PCAOB AS 2501

Indicators of Possible Management Bias (Ref: par. .21)

31. Evaluating potential bias in accounting estimates includes evaluating bias in estimates individually and in aggregate. It also includes evaluating whether bias results from the cumulative effect of changes in estimates.⁷⁹

Proposed SAS⁸⁰

The following is paragraph 32 and related application material in paragraphs A133-A136 of ISA 540 (Revised), marked to reflect changes for the proposed SAS.

Indicators of Possible Management Bias

32. The auditor should ~~shall~~ evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually

⁷⁹ See AS 2810.27.

⁸⁰ See footnote 6.

reasonable, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor ~~should shall~~ evaluate the implications for the audit. ~~When Where~~ there is intention to mislead, management bias is fraudulent in nature. (Ref: Para. A133–A136)

Application Material

Indicators of Possible Management Bias (Ref: Para. 32)

A133. Management bias may be difficult to detect at an account level and may only be identified by the auditor when considering groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods. For example, if accounting estimates included in the financial statements are considered to be individually reasonable but management’s point estimates consistently trend toward one end of the auditor’s range of reasonable outcomes that provide a more favorable financial reporting outcome for management, such circumstances may indicate possible bias by management

A134. Examples of indicators of possible management bias with respect to accounting estimates include the following:

- Changes in an accounting estimate, or the method for making it, when management has made a subjective assessment that there has been a change in circumstances.
- Selection or development of significant assumptions or the data that yield a point estimate favorable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

When such indicators are identified, there may be a risk of material misstatement either at the assertion or financial statement level. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions ~~about on~~ the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of management bias.

A135. Indicators of possible management bias may affect the auditor’s conclusion ~~about as to~~ whether the auditor’s risk assessment and related responses remain appropriate. The auditor may also need to consider the implications for other aspects of the audit, including the need to further question the appropriateness of management’s judgments in making accounting estimates. Further, indicators of possible management bias may affect the auditor’s conclusion as to whether the financial statements as a whole are free from material misstatement, as discussed in AU-C section ISA-700 or AU-C section 703(Revised).⁸¹

A136. In addition, in applying AU-C section ISA-240, the auditor is required to evaluate whether management’s judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud.⁸² Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting

⁸¹ Section 700 of SAS No. 134ISA-700 (Revised), paragraph 1444, or EBP SAS paragraph 39.

⁸² AU-C section ISA 240, paragraph 32(b) [check reference]

estimates. Indicators of possible management bias that may also be a fraud risk factor, may cause the auditor to reassess whether the auditor's risk assessments, in particular the assessment of fraud risks, and related responses remain appropriate.

See Agenda Item 4A "Appendix of Agenda Item 4" for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

22. The ASB is asked for their views about the indicators of possible management bias of ISA 540 (Revised), whether the application material provides sufficient guidance, and whether any additional changes are needed to the requirement or guidance.

Issue 12 — Overall Evaluation (ISA 540 (Revised) paragraphs 33-36 and A137-A138)

Task Force Discussion

The Estimates TF agreed with the concepts in ISA 540 (Revised) relating to overall evaluation of audit estimates based on the audit procedures performed. The Estimates TF discussed the need for this section to either align with the Evidence project (see ASB meeting agenda item 2) or to propose changes to extant AU-C section 500. The Estimates Task Force will consider the outcomes from the May 2019 ASB meeting to help inform the way forward.

Proposed SAS⁸³

The following are paragraphs 33-34 and A137-A138 of ISA 540 (Revised), marked to reflect changes for the proposed SAS.

Overall Evaluation Based on Audit Procedures Performed

33. In applying AU-C section ISA-330 to accounting estimates,⁸⁴ the auditor ~~should~~ shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A137–A138)

- 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. 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; and

⁸³ See footnote 6.

⁸⁴ AU-C section ISA-330, paragraphs 25–26

c. Sufficient appropriate audit evidence has been obtained.

34. In making the evaluation required by paragraph 33(c), the auditor ~~should~~shall take into account all relevant audit evidence obtained, whether corroborative or contradictory.⁸⁵ If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor ~~should~~ shall evaluate the implications for the audit or the auditor's opinion on the financial statements in accordance with AU-C section ISA-705 (Revised).⁸⁶

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 33)

A137. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures.⁸⁷ In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence that differs significantly from the information on which the risk assessment was based. For example, the auditor may have identified that the only reason for an assessed risk of material misstatement is the subjectivity involved in making the accounting estimate. However, while performing procedures to respond to the assessed risks of material misstatement, the auditor may discover that the accounting estimate is more complex than originally contemplated, which may call into question the assessment of the risk of material misstatement (for example, the inherent risk may need to be re-assessed on the higher end of the spectrum of inherent risk due to the effect of complexity) and therefore the auditor may need to perform additional further audit procedures to obtain sufficient appropriate audit evidence.⁸⁸

A138. With respect to accounting estimates that have not been recognized, a particular focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

See Agenda Item 4A "Appendix of Agenda Item 4" for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

23. The ASB is asked for their views about the overall evaluation of audit estimates based on the audit procedures performed as discussed above, whether the application material provides sufficient guidance, and whether any additional changes are needed to the requirement or guidance.

⁸⁵ ISA 500, paragraph 11 [need to update for AU-C 500]

⁸⁶ AU-C ISA-705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

⁸⁷ AU-C section ISA-330, paragraph A60

⁸⁸ See also AU-C section ISA-315 (Revised), paragraph 31

Issue 13 — Determining Whether Accounting Estimates are Reasonable or Misstated
(ISA 540 (Revised) paragraphs 35-36 and A139-A144; extant AU-C section 540 paragraphs .19 and .A128-.A129; PCAOB AS 2501 paragraph 30)

Task Force Discussion

The Estimates TF agreed with the concepts in ISA 540 (Revised) relating to determining whether accounting estimates are reasonable or misstated. The Estimates TF also considered paragraph 30 of PCAOB AS 2501 and concluded that the content in PCAOB AS 2501 was sufficiently similar to that in ISA 540 (Revised) and therefore the Estimates TF is not proposing any changes to align with PCAOB AS 2501.

Proposed SAS⁸⁹

The following are paragraphs 35-36 and A139-A144 of ISA 540 (Revised), marked to reflect changes for the proposed SAS.

Determining Whether the Accounting Estimates are Reasonable or Misstated

35. The auditor ~~should~~shall determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. ~~AU-C section ISA~~AU-C section ISA-450⁹⁰ provides guidance on how the auditor may distinguish misstatements (whether factual, judgmental, or projected) for the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. (Ref: Para. A12–A13, A139–A144)

36. In relation to accounting estimates, the auditor ~~should~~shall evaluate:

~~a. In the case of a fair presentation framework,~~ whether management has included disclosures, beyond those specifically required by the framework, that are necessary to achieve the fair presentation of the financial statements as a whole;⁹¹ ~~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.~~⁹²

TF note: The Estimates TF discussed the need for a reference to the application material in AU-C section 700 to include the context of making the assessment within the financial accounting reporting framework. The footnote includes a reference to the application material in AU-C section 700.

⁸⁹ See footnote 6.

⁹⁰ ~~AU-C section ISA~~AU-C section ISA-450, paragraph ~~A3A6~~A3A6

⁹¹ See also ~~AU-C section ISA~~AU-C section ISA-700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, of SAS No. 134 paragraphs ~~.16 and .A1614~~.16 and .A1614

⁹² See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 19

A139. In determining whether, based on the audit procedures performed and evidence obtained, management's point estimate and related disclosures are reasonable, or are misstated:

- When the audit evidence supports a range, the size of the range may be wide and, in some circumstances, may be multiples of materiality for the financial statements as a whole (see also paragraph A125). 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.
- The audit evidence may support a point estimate that differs from management's point estimate. In such circumstances, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement.
- The audit evidence may support a range that does not include management's point estimate. In such circumstances, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range.

A140. Paragraphs A110–A114 provide guidance to assist the auditor in evaluating management's selection of a point estimate and related disclosures to be included in the financial statements.

A141. When the auditor's further audit procedures include testing how management made the accounting estimate or developing an auditor's point estimate or range, the auditor is required to obtain sufficient appropriate audit evidence about disclosures that describe estimation uncertainty in accordance with paragraphs 26(b) and 29(b) and other disclosures in accordance with paragraph 31. The auditor then considers the audit evidence obtained about disclosures as part of the overall evaluation, in accordance with paragraph 35, of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

A142. [AU-C section ISA-450](#) also provides guidance regarding qualitative disclosures⁹³ and when misstatements in disclosures could be indicative of fraud.⁹⁴

A143. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation⁹⁵ includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the transactions and events in a manner that achieves fair presentation. For example, when an accounting estimate is subject to a higher degree of estimation uncertainty, the auditor may determine that additional disclosures are necessary to achieve fair presentation. If management does not include such additional disclosures, the auditor may conclude that the financial statements are materially misstated.

⁹³ [AU-C section ISA 450](#), paragraph A17 [update par references to GAAS]

⁹⁴ [AU-C section ISA 450](#), paragraph A22 [update par references to GAAS]

⁹⁵ [AU-C section ISA 700 \(Revised\)](#), paragraph 14 [update par references to SAS 134]

A144. AU-C section ISA-705 (Revised)⁹⁶ provides guidance on the implications for the auditor’s opinion when the auditor believes that management’s disclosures in the financial statements are inadequate or misleading, including, for example, with respect to estimation uncertainty.

See Agenda Item 4A “Appendix of Agenda Item 4” for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

24. The ASB is asked for their views for determining whether accounting estimates are reasonable or misstated as shown above, whether the application material provides sufficient guidance, and whether any additional changes are needed to the requirement or guidance.

Issue 14 — Communication with Those Charged with Governance

(ISA 540 (Revised) paragraphs 38 and A146-A148; extant AU-C section 540 paragraphs A127-A128)

Task Force Discussion

The Estimates TF agreed with the concepts in ISA 540 (Revised) relating to communications with those charged with governance.

Proposed SAS⁹⁷

The following is paragraph 38 and related application material in paragraphs A127-A128 of ISA 540 (Revised), marked to reflect changes for the proposed SAS.

Communication with Those Charged With Governance, Management, or Other Relevant Parties

38. In applying AU-C section ISA-260 (Revised)⁹⁸ and AU-C section ISA-265,⁹⁹ the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity’s significant accounting practices and significant deficiencies and material weaknesses in internal control identified during the audit, respectively. In doing so, the auditor should ~~shall~~ consider the matters, if any, to communicate regarding accounting estimates and take into account whether the reasons given to the risks of material misstatement relate to estimation uncertainty, or the effects of complexity, subjectivity or other inherent risk factors in making accounting estimates and related disclosures. In addition, in

⁹⁶ AU-C section ISA 705 (Revised), paragraphs 22–23 [update par references to SAS 134]

⁹⁷ See footnote 6.

⁹⁸ AU-C section ISA 260 (Revised), The Auditor’s Communication with Those Charged with Governance, paragraph 12+6(a)

⁹⁹ AU-C section ISA 265, paragraph 119

certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators, ~~or prudential supervisors~~. (Ref: Para. A146–A148)

Communication with Those Charged With Governance, Management or Other Relevant Parties (Ref: Para. 38)

A146. In applying AU-C section ISA-260 (Revised), the auditor communicates with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures.¹⁰⁰ Appendix 2 includes matters specific to accounting estimates that the auditor may consider communicating to those charged with governance.

TF note: Estimates TF to discuss whether to include appendix 2. Estimates TF to ensure any amendments from SAS 134 or 135 are captured here once those SASs are issued.

A147. AU-C section ISA-265 requires the auditor to communicate in writing to those charged with governance significant deficiencies and material weaknesses in internal control identified during the audit.¹⁰¹ Deficiencies in controls, which may also be ~~Such~~ significant deficiencies or material weaknesses, may include those related to controls over:

- a. The selection and application of significant accounting policies, and the selection and application of methods, assumptions and data;
- b. Risk management and related systems;
- c. Data integrity, including when data is obtained from an external information source; and
- d. The use, development and validation of models, including models obtained from an external provider, and any adjustments that may be required.

TF note: The Estimates TF was concerned that the lead-in to the bulleted list implies that the items listed would always be significant deficiencies, therefore the Estimates TF is proposing revisions to the lead in. The Estimates TF also questioned the need for this list because the matters are broad and may not necessarily be helpful.

A148. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators, ~~or prudential supervisors~~. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, ~~in some jurisdictions~~, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while other regulators may seek to understand the auditor's views on significant aspects of the entity's operations including the entity's costs estimates. This communication may be helpful to the auditor

¹⁰⁰ AU-C section ISA 260 (Revised), paragraph 16(a)

¹⁰¹ AU-C section ISA 265, paragraph 9 [TF to check paragraph reference]

in identifying, assessing and responding to risks of material misstatement.

TF note: The Estimates TF will consider the example to make it more appropriate in the U.S.

See Agenda Item 4A “Appendix of Agenda Item 4” for excerpts of ISA 540 (Revised), extant AU-C section 540, and PCAOB AS 2501 for reference purposes.

Action Requested of the ASB

25. The ASB is asked for their views for communicating with those charged with governance as shown above, whether the application material provides sufficient guidance, and whether any additional changes are needed to the requirement or guidance.
26. Does the ASB believe that items a-d in paragraph A147 are helpful to include in the proposed SAS or should they be removed?