Identifying and Assessing the Risks of Material Misstatement

10. In applying ISA 315 (Revised), the auditor is required to identify and assess the risks of material misstatement, at the financial statement and assertion levels, including determining whether any of the risks of material misstatement identified are, in the auditor's judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate, the auditor shall take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including ~~the following factors~~: (Ref: Para. A44G–A44N)

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

        (i) The extent to which the method used necessarily involves ~~to make an accounting estimate~~ specialized skills or knowledge, including with respect to ~~involves~~ the use of a ~~complex~~ model~~s~~; or (Ref: Para. A44O–A44P)

        (ii) The difficulty in obtaining relevant and reliable data and maintaining the integrity of that data, including internal data from sources outside the general and subsidiary ledgers and data from external sources. (Ref: Para. A44Q)

    (b) The use of judgment by management in making the accounting estimate, including judgment with respect to ~~in the selection of~~ methods, assumptions, and sources of relevant and reliable data ~~, and the interpretation of data~~; or (Ref: Para. A44R–A44U)

    (c) Estimation uncertainty, including the sensitivity of the accounting estimate to the use of particular data, assumptions and methods; (Ref: Para. ~~A44R~~A44V–A49A)

    ~~(d) Other relevant factors (Ref: Para A49B).~~

Responses to the Assessed Risks of Material Misstatement

11A. In responding to the assessed risks of material misstatement in accordance with paragraphs 13–13D, the auditor shall consider whether specialized skills or knowledge are required ~~in order to obtain sufficient appropriate audit evidence~~ to design and perform audit procedures, or to evaluate audit results. (Ref: Para. A44A–A44F)

[Note: a clean version of paragraph 13 is also available]

13. In applying ISA 330, the auditor is required to design and perform further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. In doing so, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that relevant controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. With respect to accounting estimates: (Ref: Para. A57A–A57H)

    (a) If the assessed risk of material misstatement is low ~~without regard to~~, and that assessment does not include an expectation that relevant controls are operating effectively, the auditor shall consider whether ~~a~~an overall procedure ~~directed to the~~

~~estimate overall~~ would provide sufficient appropriate audit evidence regarding the assessed risk of material misstatement in the circumstances~~; or~~. (Ref: Para. A57I)

(b) If the assessed risk of material misstatement is ~~not low, or is low based on~~low and that assessment includes an expectation that relevant controls are operating effectively, the auditor's ~~shall perform~~further audit procedures ~~in accordance with~~ shall include tests of controls to obtain audit evidence about the applicable matters in paragraphs 13A–13C~~, as applicable~~. Such procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10. (Ref: Para. A57J)

(c) If the assessed risk of material misstatement is not low, the auditor's further audit procedures shall include procedures to obtain audit evidence about the applicable matters in paragraphs 13A–13C. Such procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needs to be. ~~needed. If the assessed risk is low because of controls, the procedures shall include tests of those controls designed to obtain audit evidence about the matters in paragraphs 13A–13C.~~ (Ref: Para. A57K–A57M)

13A. ~~When required by~~In complying with paragraphs 13(b) or 13(c), ~~and~~ when the reasons for the assessment given to the risk of material misstatement include complexity in making the accounting estimate, the auditor shall ~~design and perform further audit procedures to address~~ obtain [sufficient appropriate] audit evidence about the applicable matters below~~, as applicable~~: (Ref: Para A57N-A57O)

(a) When~~ther~~ the method necessarily involves specialized skills or knowledge, ~~(~~including~~, when applicable,~~ with respect to ~~the use of~~ a complex model~~) is appropriate, including~~: ~~-~~(Ref: Para. A57P-A59A)

(i) Whether the method is appropriate in the context of the applicable financial reporting framework;

(ii) Whether data (and other information used to develop assumptions) to which the accounting estimate is particularly sensitive is relevant and~~,~~ reliable~~, accurate and complete. This~~, ~~includinges both internal data from sources outside the general and subsidiary ledgers and data from external sources~~;

(~~ii~~b) When management uses a complex method, including a complex model, whether the calculations have been accurately performed and appropriately reflect the application of the method; Ref: Para A59B-A59H)

~~(b) When the entity uses a complex IT system to deal with a complex accounting estimation process, the risks arising from the complex IT system.~~

13B. In complying with~~When required by~~ paragraph 13(b) or 13(c), ~~and~~ when the reasons for the assessment given to the risk of material misstatement include the use of judgment by management ~~'s judgment~~ in making the accounting estimate, the auditor shall ~~design and perform further audit procedures to~~ obtain [sufficient appropriate] audit evidence about ~~address~~ the applicable matters below~~, as applicable~~:

(a) When the accounting estimate is particularly sensitive to changes in data and assumptions~~Whether assumptions and data sources to which the accounting~~

~~estimate is particularly sensitive are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework. This includes, when applicable, whether~~:

(i) Whether the assumptions and data are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework;

(ii) Whether m~~M~~anagement's selection of methods, assumptions and data (including external information sources) are indicators of possible management bias; (Ref: Para. A59I-A59J)

(iii) Whether m~~M~~anagement considered alternatives to ~~those~~ the assumptions and whether the assumptions are consistent with each other. (Ref: Para. A59K–A59M);

(iv) Whether management has appropriately understood or interpreted data, including with respect to contractual terms. (Ref: Para. A59N)

(v~~ia~~) Whether m~~M~~anagement's judgments in applying the requirements of~~, which are acceptable under~~ the applicable financial reporting framework~~,~~ are appropriate in the ~~particular~~ circumstances of the entity; ~~-~~(Ref: Para. A59O)

(vi~~iii~~) Whether c~~C~~hanges in methods, assumptions and data sources from the prior period are appropriate (Ref: Para. A59P–A59R);

(b) When relevant to the appropriateness of the assumptions to which the accounting estimate is particularly sensitive ~~or the appropriate application~~or the appropriate application of the requirements of the applicable financial reporting framework, ~~the auditor shall also evaluate~~whether management has the~~'s~~ intent to carry out specific courses of action and its ability to do so (Ref: Para. A59S);

(c) When management uses a complex model (see also paragraph 13A(a)), whether the complex model has been applied consistently and whether, when applicable: (Ref: Para. A59T)

(i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;

(ii) Changes, if any, from the previous period's model are appropriate in the circumstances; and

(iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework.~~ (Ref: Para. A76),; and~~

~~(iii) The selection of valuation technique, assumptions or data meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;~~

13C. In complying with ~~When required by~~ paragraph 13(b) or 13(c), ~~and~~ when the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor shall ~~design and perform further audit procedures to~~ obtain [sufficient appropriate] audit evidence about ~~address~~ the applicable matters below~~, as applicable~~: (Ref: Para. A59U)

~~(a) Whether, in the context of the applicable financial reporting framework, the steps, if any, management has taken appropriate steps to understand and has adequately addressed the effect of estimation uncertainty.~~

(a~~b~~) Having regard to t~~T~~he extent to which the accounting estimate is particularly sensitive to the use of ~~particular~~ certain data, assumptions, and methods:~~;~~

(i) ~~(c)~~ Whether management's point estimate or range (or an element thereof) is reasonable. (Ref: Para. A59V-A59Z)

~~(i)~~(ii) ~~(d)~~ Whether the disclosures in the financial statements that describe the estimation uncertainty are appropriate~~reasonable~~ in the context of the applicable financial reporting framework (Ref: Para. A60A~~F~~–A60B~~G~~)

(b) When, in the auditor's judgment, management has not adequately addressed the effect of estimation uncertainty (see paragraph 8(c)(iv)), the auditor shall develop a point estimate or range, using appropriate methods, data and assumptions, to evaluate management's point estimate. If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. The auditor shall evaluate the range of reasonable outcomes in the context of the requirements of the applicable financial reporting framework (Ref: Para A60C–A60G)

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Application and Other Explanatory Material

Specialized Skills or Knowledge (Ref: Para. 9A, 11A)

A44A. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.[1] This may include, as necessary, the involvement of those with specialized skills or knowledge. In addition, ISA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to perform the audit engagement[2] ~~P~~During the course of the audit, the auditor may identify the need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A44B. Matters that may affect the auditor's consideration of whether specialized skills or knowledge is required include, for example:

- The nature of the accounting estimate ~~in~~ for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance liabilities).

[1] ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

[2] ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

- The degree of estimation uncertainty.
- Complex calculations or specialized models are involved, for example, when estimating fair values when there is no observable market.
- 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 is inconsistent or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.
- The degree of judgment needed.
- The information technology used in making the accounting estimate.

A44C. For the majority of accounting estimates, even when there is estimation uncertainty, it is unlikely that specialized skills or knowledge will be required. For example, for most audits it is unlikely that specialized skills or knowledge would be necessary for an auditor to evaluate a warranty provision.

A44D. The auditor may not possess the specialized skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to obtain it from an auditor's expert. ISA 620[3] establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A44E. Further, in some cases, the auditor may conclude that it is necessary to obtain specialized skills or knowledge related to specific areas of accounting or auditing. An example of such a case may be the allowance for expected credit losses for an internationally active banking institution or the insurance liability for a life insurance entity. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organization outside of the auditor's firm. Where such individuals perform audit procedures on the engagement, they are part of the engagement team and, accordingly, they are subject to the requirements in ISA 220.

A44F. Depending on the auditor's understanding and experience of working with the auditor's expert or those other individuals with specialized skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 10)

A44G. ~~ISA 200 explains that the risk of material misstatement at the assertion level consists of two components: inherent risk and control risk, which can either be assessed separately or in combination. ISA 200 also explains that control risk is a function of the effectiveness of the design, implementation and maintenance of the entity's internal control by management.~~ Obtaining an understanding of the entity and its environment, including the entity's internal control, as required by paragraph 8~~,~~ assists the auditor in identifying areas of the financial statements that may be subject to potential misstatement and relevant risk factors that may give rise to potential risks of material misstatement

[3] ISA 620, *Using the Work of an Auditor's Expert*

related to accounting estimates. ~~An understanding of the entity's internal control may be particularly important for accounting estimates that are complex to make.~~

A44H.~~—~~Paragraph 10 requires the auditor, in assessing the risks of material misstatement, to take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including complexity, or the use of judgment by management, in making the estimate, and estimation uncertainty. The sources behind the factors ~~(complexity, judgment and estimation uncertainty)~~ that give rise to the risk of material misstatement may be interrelated. For example, the financial reporting framework may ~~inherently result be a source of~~be an inherent source of estimation uncertainty (as it may require an assumption ~~that may cause an inherent lack of precision~~when information is unavailable to make a more precise estimate), complexity (as it may require the use of a complex method) and judgment (as it may require management to choose a method to make the accounting estimate). ~~When there is a high degree of judgment, the accounting estimate may be more susceptible to management bias and, therefore, an increase in estimation uncertainty.~~

[To conform with final wording in paragraph 10]

A44I~~K~~. For some accounting estimates, ~~however,~~ the extent of ~~estimation uncertainty,~~ complexity, ~~or~~ judgment or estimation uncertainty ~~involved in making the accounting estimate~~ may be such that the assessed risk of material misstatement is not low, for example:

- Accounting estimates relating to the outcome of litigation.
- Accounting estimates for financial instruments not publicly traded.
- Accounting estimates for which a highly specialized entity-developed model is used or for which there are assumptions or data that cannot be observed in the marketplace.
- Accounting estimates that collate, weight and integrate assumptions and data from a wide range of internal and external sources, such as an expected credit loss model in a financial institution that is active in different markets or a technical provision relating to an insurance contract.
- Estimates of development costs of a new medicine.
- Estimates relating to undeveloped mineral resources.
- Valuation of goodwill in a business combination

A44J.~~I. Some accounting estimates may have a high~~ The auditor's assessment of the risk of material misstatement ~~because of~~as not low may result from a combination of complexity, judgment and estimation uncertainty, ~~judgment, and complexity~~or may be influenced primarily by one of the factors. For example, estimates of expected credit losses ~~models~~ are often complex because they require the use of a highly specialized entity-developed model and also involve high estimation uncertainty and judgments about future matters. ~~Other accounting estimates may have a high risk of material misstatement because only on factor is present. For example~~On the other hand, an obsolescence provision for ~~inventory~~an entity with a wide array of different inventory types may require complex systems and processes to make the accounting estimate, but in making the accounting estimate little judgment is involved and the estimation uncertainty is low.

~~Equally, other~~Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant ~~judgments~~judgment, for example, an accounting estimate that requires a single critical judgment such as ~~a clearly identifiable, level 3 financial instrument or~~ a legal contingency.

A44K~~J~~. ~~Examples of~~For some accounting estimates ~~that may give rise to a low~~ , the auditor's assessment of the risk of material misstatement is low and the assessment does not include an expectation ~~,~~ that controls are operating effectively. Examples may include:~~:~~

- ~~Accounting estimates arising in entities that engage in business activities that are not complex or do not require significant judgment in making the accounting estimates. For example, the depreciation of a warehouse or the translation of foreign currency balance.~~

- ~~Accounting estimates that are frequently made and updated because they relate to routine transactions.~~

- An allowance for doubtful accounts in a smaller, less complex entity.

- Depreciation calculations for an entity using a single depreciation method for property and equipment and a relatively low level of additions or disposals.

- Accounting estimates based on data that is readily available, such as published interest rate or foreign exchange rate data or exchange-traded prices of securities, and few or no assumptions.

- ~~Accounting estimates where the method of measurement prescribed by the applicable financial reporting framework is simple and applied easily to the asset or liability requiring measurement.~~

- ~~Accounting estimates where the model used to measure the accounting estimate is well-known or generally accepted, provided that the assumptions or data used in the model are observable.~~

Significant Risks

A44L. Paragraph 28 of ISA 315 (Revised) and the related application material include factors that are required to be considered when identifying significant risks. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.[4]

A44M. In some cases, the estimation uncertainty of an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570 (Revised)[5] establishes requirements and provides guidance in such circumstances.

Other Relevant Factors

A44N~~9B~~. In addition to complexity, judgment and estimation uncertainty, there may be o~~O~~ther relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement. These may include the extent to which the accounting estimate is subject to, or affected by:~~, including determining whether any of those risks are significant risks, may include~~:

4 ISA 315 (Revised), paragraph 29

5 ISA 570, (Revised), *Going Concern*

- Changes in the method, assumptions or data used to make the accounting estimate;
- The susceptibility of the accounting estimate to management bias or fraud; and
- The r~~R~~egulatory environment, including relevant regulatory requirements.
- ~~The actual or expected magnitude of an accounting estimate.~~
- ~~The recorded amount of the accounting estimate (that is, management's point estimate) in relation to the amount expected by the auditor to be recorded.~~
- ~~Whether management has used an expert in making the accounting estimate.~~
- ~~The outcome of the review of previous period accounting estimates.~~

The Complexity in Making the Accounting Estimate~~s~~

The Method Used in Making the Accounting Estimate~~s~~ (Ref: Para. 10(a)(i))

~~A44N~~A44O.~~Risks~~ The risk of material misstatement related to the method used in making the accounting estimate may arise from various sources such as:

- The financial reporting framework. The requirements of the applicable financial reporting framework may result in the need for a complex method.
- The nature of the entities' business or organizational structure. A complex business model may give rise to errors not being detected within calculations or challenges in the aggregation of the data.
- The sophistication and integrity of the information systems. Data that is used to make the accounting estimates may be based on complex system-generated data which may require effective information technology general controls, and controls over the flow of data through the system.
- Fair value accounting estimates for which a highly specialized entity-developed model is used.

A44P. [Application material that explains that:

- *This is the method that management uses and is not the same as the obligation for the auditor to consider whether he/she needs specialized skills or knowledge.]*
- *This does not mean that management needs to engage an expert*

The Data on Which the Accounting Estimates Are Based (Ref: Para. 10(a)(ii))

A~~A~~44Q. The risk of material misstatement related to the difficulty in obtaining relevant and reliable data may arise from various sources such as:

- The reliability of the data source. Data from certain sources may be more reliable than from others. For example, data from outside the general and subsidiary ledgers may be more susceptible to misstatements because in some entities it may be difficult to determine whether there were appropriate controls and governance over that data as they may not have been documented. The observability of the data also influences the reliability of the data source. The data that is used to make an accounting estimate may be unobservable because it is, for example, based on quotes from an inactive market. In general, the reliability of the data decreases when the data is less directly observable.

- Information from the data source. ~~Challenges in obtaining sufficient and appropriate audit evidence. For some data, it might be challenging to obtain sufficient and appropriate audit evidence because it is purchased from an external data source.~~ Some external data sources will not disclose information about the data, such as how the data is accumulated, calculations in the production of the data, and the process used to generate the data (including any controls over the process that may be relevant in determining the reliability of the information provided), ~~because of~~due to confidentiality ~~and~~ or for proprietary reasons.
- The complexity in preparing the data. There may be a higher risk of ~~incorrect modifications when data~~errors in the data when it is aggregated, compressed, transformed or otherwise modified.
- The volume of data or obtaining data ~~that comes~~ from a wide variety of sources, leading to a risk~~s~~ that the data may be inappropriately used, or may be incomplete or from the incorrect data set.

Judgment (Ref: Para. 10(b))

A44R Judgment may be used by management in the selection and interpretation of data and other information, the selection and application of appropriate methods, and the selection and development of appropriate assumptions.

A44S. The risk of material misstatement related to judgment involved in making accounting estimates may come from many sources, including:

- The selection of inappropriate methods, assumptions and data, for example:
    - o The method selected may not ~~be in compliance~~comply with the applicable financial reporting framework.
    - o Management may be biased in the selection of a method, an assumption or data.
    - o Management may select a data source that is not relevant and reliable.
- The applicable financial reporting framework, which may require significant judgment through, for example, a long forecast period.
- Management may lack the experience or competence to interpret data, to select appropriate methods and assumptions, or consider relevant scenarios. When management lacks the competence or experience in a certain area and decides not to use a management's expert, there may be a risk that management may not make the necessary judgments that are not appropriate in light of the applicable financial reporting framework.
- For example, the determination of cash inflow or outflow arising from commercial supplier or customer rebates may depend on very complex contractual terms which require specific expertise or competence.

~~A44Q~~A44T. Examples of accounting estimates that may have a high degree of judgment include the following:

- Accounting estimates that are based on future cash flows.

- Accounting estimates that are based on complex legal or contractual terms for which no evidence of legal precedent is available.
- Accounting estimates with a long forecast period.

A44U. When there is a high degree of judgment, the accounting estimate may be more susceptible to management bias.

[Elaborate on point made in paragraph A44S by adding an example]

Estimation Uncertainty (Ref: Para. 10(c))

A44V. The risk of material misstatement related to estimation uncertainty may arise from various sources such as:

- The applicable financial reporting framework, which may require:
  - o A method used to make the accounting estimates that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of fair value accounting instead of historical costs.
  - o The use of assumptions that inherently have a high level of estimation uncertainty, such as future cash flows for a long-~~-~~term contract, or that are based on data that is unobservable and are therefore difficult for management to ~~make~~develop.
  - o Disclosures about estimation uncertainty. There may be a risk of material misstatement related to the failure to make a material disclosure about the 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 assumption may therefore be dependent on data that are hard to observe.

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- Accounting estimates that are not ~~calculated~~ determined using recognized measurement techniques.
- Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the estimation; that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate may not be an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, the significant risks relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them (see paragraphs A120-A123).

The Sensitivity of the Accounting Estimate to Changes in Particular Data, ~~and~~ Assumptions and Methods

A49A. As described in paragraph A38A, some accounting estimates may be particularly sensitive to certain data, ~~and~~ assumptions, and methods. For these accounting estimates the sensitivity may influence the degree of estimation uncertainty associated with an accounting estimate, which in turn may influence the accounting estimate's susceptibility to management bias. In these circumstances the auditor's application of professional skepticism is particularly important and the auditor may, for example, compare its own independent analysis of the data and assumptions with management's, including obtaining an understanding of any differences between them.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 13)

[Subheading~~s~~ needed ~~in this section~~]

~~A85. Testing the operating effectiveness of the controls is required by ISA 330 when:~~

~~(a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls over the process are operating effectively; or~~

~~(b) Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.~~

A57A. Some entities, such as large banks, insurers, and telecommunication entities, make extensive use of IT to conduct their business or have a high number of accounting estimates, many of which are judgmental or complex, in their financial reports. For audits of these entities, it may not be possible or practicable for the auditor to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level for certain accounting estimates. Other factors that may indicate that substantive procedures alone may not be able to provide sufficient appropriate audit evidence at the assertion level include:

- The volume of transactions (for example, a high volume of transactions may occur in a large bank or telecommunication entity, making it more difficult to design substantive procedures that may alone provide sufficient appropriate audit evidence at the assertion level);
- Whether significant information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported. For such assertions, ~~significant~~ audit evidence may be available only in electronic form. 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. ~~Furthermore~~In addition, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.

A57B. In some jurisdictions, 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 work to provide assurance on internal controls.

A57C~~84~~. Testing the operating effectiveness of controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:

- Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.
- The accounting estimate is derived from the routine processing of data by the entity's accounting system.
- Management's method of making the accounting estimate involves a large volume of data, processing by IT systems, or large volumes of transactions (for example, for an entity with an actively managed portfolio of investments).

Considerations Specific to Smaller Entities

A57D Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.

[Subheading needed]

~~A52. ISA 330 requires the auditor to design and perform audit procedures whose nature, timing and extent are responsive to the assessed risks of material misstatement in relation to accounting estimates at both the financial statement and assertion levels.P18F[6]P Paragraphs A53–A115 focus on specific responses at the assertion level only. Paragraph 13(c) of ISA 700 (Revised) requires the auditor to evaluate whether, in view of the requirements of the applicable financial reporting framework, the accounting estimates made by management are reasonable.~~

~~A52A. Consistent with the requirements of ISA 330, the nature, timing, and extent of audit procedures are based on and are responsive to the assessed risks of material misstatement at the assertion level. In this regard, accounting estimates vary widely in terms of complexity, judgment, and estimation uncertainty, leading to varying types of assessed risks of material misstatement. Similarly, the auditor's response will vary depending on the extent to which the accounting estimate is subject to, or affected by relevant factors, including complexity, or the use of judgment by management, in making the estimate, and estimation uncertaintyThe risks of material misstatement and consequent procedures to be performed on a accounting estimate that is not subject to, or affected by, complexity, judgment, and estimation uncertainty do not drive the risk of material misstatement at the assertion level will vary significantly from those performed on a complex accounting estimate with high estimation uncertainty.~~

~~[6] ISA 330, paragraphs 5–6~~

~~A52B.[Application material to be added to explain that, for significant risks, the auditor is required to understand the controls (ISA 315, paragraph 29) but is not required to test operating effectiveness unless one of the requirements of (ISA 330, paragraph 8) are triggered. If the auditor does decide to rely on controls over a significant risk, then the controls must be tested in the current period to comply with ISA 330, paragraph15)]~~

A57E~~8D~~. In designing ~~the~~ further audit procedures, ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance or disclosure (that is, the inherent risk), and whether the risk assessment takes account of relevant controls (that is, control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively.

A57F~~58C~~. Paragraph A40 of ISA 200 states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, the auditor may make separate or combined assessments of inherent and control risk. Although this ISA neither implies nor requires a separate assessment of inherent and control risk, it highlights the importance of the auditor's consideration of both inherent and control risk in designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level in accordance with ISA 330.

A57G~~58E~~. In identifying the risks of material misstatement for accounting estimates, paragraph 10 requires the auditor to take into account the extent to which the estimate is subject to, or affected by, complexity or use of judgment by management in making the accounting estimate, estimation uncertainty, or other relevant factors (i.e., the reasons for the assessment given to the risk of material misstatement).

[To align with final wording in paragraph 10]

A57H~~8F~~. Accounting estimates, by their nature, will vary and be subject to differing levels of assessed risk of material misstatement, and different reasons for the assessment given to those assessed risks. Therefore, the nature, timing and extent of the procedures performed to respond to the assessed risks of material misstatement at the assertion level, in accordance with ISA 330, will also vary in relation to the nature of the accounting estimate, the level of assessed risk and the reasons for the assessment given to the risk.

~~Considerations Specific to Smaller Entities~~

~~A86. Controls over the process to make an accounting estimate may exist in smaller entities, but the formality with which they operate varies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is likely to be substantive in nature, with the auditor performing one or more of the other responses in paragraph 13.~~

Accounting Estimates with Low Assessed Risk of Material Misstatement ~~before Taking into Account Controls~~ Assessment Does Not Include Ann ~~and No~~ Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(a))

A57I~~8G~~. For some accounting estimates, such as those described in paragraph A44J, the extent of complexity, judgment, or estimation uncertainty may be such that the assessed risk of material misstatement is low and that assessment does not include an expectation that relevant controls are operating effectively~~relevant controls (that is, the inherent risk), is low~~. In these circumstances, the auditor may determine that an overall procedure ~~directed to the estimate overall~~ is sufficiently responsive to the assessed risk of material misstatement. ~~For example, the auditor may determine that events occurring up to the date of the auditor's report may provide sufficient appropriate audit evidence about an accounting estimate.~~ This might be the case when the sale of the complete inventory of a superseded product shortly after the period end provides sufficient appropriate evidence relating to the estimate of its net realizable value. For such accounting estimates ~~with low assessed risk of material misstatement, without regard to relevant controls~~, the following procedures may be appropriate:

- Obtaining audit evidence about events occurring up to the date of the auditor's report;
- Developing a point estimate or range to evaluate management's point estimate;
- ~~Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures;~~ and
- Performing substantive analytical procedures.

~~While the procedures liste~~If an overall procedure is not sufficiently responsive to the risk of material misstatement, the auditor may find ~~in~~ paragraphs 13A-C ~~are not required when the risk of material misstatement is low, these procedures may also be~~ useful in designing further audit procedures~~to the auditor in designing and performing procedures under paragraph 13A~~.

Accounting Estimates with Low Assessed Risk of Material Misstatement ~~and that~~ Assessment Includes an Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(b))

A57~~8~~J. As indicated in paragraph 13(b), the auditor may have assessed the risk of material misstatement as low based on an expectation that relevant controls are operating effectively. When this is the case, the auditor is required to perform tests of the relevant controls to obtain evidence of their operating effectiveness in accordance with ISA 330. In some circumstances, the tests of controls may not be sufficient, by themselves, to appropriately address the factors giving rise to the assessed risk of material misstatement. In other circumstances, the tests of controls may be sufficient to respond to the assessed risks of material misstatement for certain assertions, but not others. ~~In designing the tests of controls, paragraph 13(b) requires the auditor to determine whether such tests will provide evidence of the operating effectiveness of the controls in addressing the matters in paragraphs 13A to 13C, specifically, the effect of complexity, judgment or estimation uncertainty, as applicable, on the assessed risk of material misstatement.~~

~~(Ref. Para: 13(c))~~

Accounting Estimates with ~~a~~ an Assessed Risk of Material Misstatement that is ~~Other than~~Not Low (Ref. Para: 13(c))

A57~~8~~K. On the other hand, for some accounting estimates, such as those described in paragraph A44K, the extent of complexity, judgment or estimation uncertainty (either individually or in combination) is more likely to influence the auditor's assessment of the risk of material misstatement for the estimate (that is, the auditor's assessment of the risk of material misstatement may be higher as the extent of complexity, judgment and estimation uncertainty involved increases). ~~Although there may be some level of judgment and estimation uncertainty for all accounting estimates, certain conditions or circumstances may result in the judgment involved in making the estimate, or the inherent estimation uncertainty, rising to a level such that more specific procedures are needed to appropriately respond to the assessed risks of material misstatement at the assertion level. In addition, complexity may arise from several sources, such as the requirements of the applicable financial reporting framework, the nature of the entity's business, or the sophistication of the entity's IT system and related integrity of data used in making the estimate.~~

A57L~~8l~~. In these circumstances, paragraph 13c~~b~~ requires the auditor to design and perform procedures to address the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needed.

A57M~~58J~~. Paragraphs 13A to 13C describe the types of matters that the auditor is required to address in designing and performing ~~the~~ further audit procedures ~~in these circumstances~~when the assessed risk of material misstatement is not low. As explained in ISA 330,[7] the nature of the procedures is of most importance in responding to the assessed risks. In addition, the reasons for the assessment given to a risk are relevant in determining the nature of audit procedures.[8] Therefore, the auditor's consideration of inherent risk is particularly important in designing the further audit procedures because the auditor's assessment of the risk of material misstatement may be higher as the extent of complexity, judgment and estimation uncertainty involved increases, as noted in paragraph ~~AX6~~A58H. The timing and extent of the further audit procedures will vary based on the assessed risk of material misstatement.

[Subheading: Complexity] (Ref: Para. 13A)

[The Task Force is going to give further consideration to the factors and their interrelationship. This may be done in the introduction, the application material, or perhaps an appendix. There may need to be some amendments to the application material related to the work effort as a consequence of this.]

A57N [Application material to explain that (a) not all the matters below might be applicable and (b) that the nature, timing, and extent of procedures performed will vary based on the assessed risk of material misstatement.]

A57O. In obtaining [sufficient appropriate] audit evidence about the matters in paragraphs 13A-13C, management's use of IT (for example, in making the accounting estimate, processing data, or making calculations) is an important consideration.

7 ISA 330, paragraph A5

8 ISA 330, paragraph A10

~~Complex Models~~

Appropriate Use of Specialized Skills and Knowledge by Management (Ref: Para. 13A(a))

A57P. When management's method necessarily involves specialized skills or knowledge, an important factor that the auditor may consider is whether there were other reasonably available valuation concepts, techniques or factors, types of assumptions or sources of data that, in the circumstances, might have been more appropriate, or more generally accepted, in the context of the applicable financial reporting framework;

A57Q~~58Hb~~.ISA 500 contains requirements and guidance regarding the auditor's responsibilities to consider the relevance and reliability of information to be used as audit evidence. ~~When designing and performing procedures~~ For~~regarding whether~~ data (and other information used to develop assumptions) to which the accounting estimate is particularly sensitive is relevant and~~,~~ reliable~~, accurate and complete,~~, the auditor may design and perform procedures to address the matters below:~~ whether~~

- Whether the data is relevant and reliable in the context of the estimation method and the financial reporting framework;~~,~~ and
- W~~w~~hether the integrity of the data has been maintained in applying the method, may be important.

A59A~~104~~. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

Evaluating the U~~u~~se of M~~m~~odels (Ref: Para. 13A~~B~~(b~~a~~)~~(i)~~)

A59B~~74~~. In some cases~~, particularly when making fair value accounting estimates,~~ management may use a model to make an accounting estimate. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.

A59C. The nature and extent of the procedures to be performed ~~over~~with respect to the model depends on ~~the~~its complexity~~ of the model~~. When a complex model is used, the assessed risk of material misstatement is likely to be higher and, therefore, the more persuasive the audit evidence that may need to be obtained. Therefore, the procedures done to meet paragraphs 13(a)(i) and (ii) may be more extensive than for other models

A59D~~75~~. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.

A59E~~76~~. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
  - The model's theoretical soundness;

- ~~and~~ The model's mathematical integrity;
- ~~, including the appropriateness of model parameters.~~
- The ~~consistency~~accuracy and completeness of the model's data and assumptions;~~ with market practices.~~ and
- The model's output as compared to actual transactions.

• Appropriate change control policies and procedures exist.

[To align more closely with A25A]

A59F. [Add application material that the risk of material misstatement related to a model can come from complexity and judgment. Refer to paragraph in the application material related to judgment that deals with judgment in a model]

~~data or assumptions obtained from~~

E~~e~~xternal information~~data~~ sources ~~(ref: para. 13AB(a), 13C(b))~~

A59G~~83B~~. ISA 500 contains requirements and guidance regarding audit evidence considerations when an external information~~data~~ source is used.

Data from outside the general and subsidiary ledgers

A59H. [*To develop application material*]

[Subheading: Judgment]

Management's Selection of Methods, Assumptions and Data~~Assumptions and data used by management~~ (Ref: Para. 13BA(a)(ii)~~, 13B(a)~~)

A59I. *[To develop further application material]*

A59J~~108~~. Support for significant assumptions derived from management's knowledge may be obtained from management's continuing processes of strategic analysis and risk management. Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the assumptions through inquiries of and discussions with management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

Consistency and Consideration of Alternative Assumptions (Ref: Para. 13B(a)(iii))

A59K~~103~~. Management may evaluate alternative assumptions or outcomes of the accounting estimates through a number of methods, depending on the circumstances. One possible method used by management is to undertake 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 can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A59L~~105~~. This is not intended to suggest that one particular method ~~of addressing estimation uncertainty (such as sensitivity analysis)~~ is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed ~~how estimation uncertainty may affect~~ the effect on accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate.

Considerations specific to smaller entities

A59M~~106~~. Smaller entities may use simple means to assess alternative assumptions or outcomes~~the estimation uncertainty~~. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative outcomes~~ or otherwise address the estimation uncertainty of the accounting estimate~~. In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation of the financial statements.

Complex ~~Legal or~~ Contractual Terms (Ref: Para. 13B(a)(iv))

A59N~~83A~~. An accounting estimate may be based on data that needs to be interpreted. For example, a contract may include complex terms that management need to understand and interpret based on the facts and circumstances of the entity. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

- Consider whether specialized skills or knowledge are needed ~~in order~~ to obtain sufficient appropriate audit evidence;
- Enquire of the entity's legal counsel regarding the legal or contractual terms;
- Confirm the completeness of the contractual terms with the counterparty;
- Inspect the underlying contracts, and:
- Obtain an understanding of, and evaluate, the underlying business ~~rationale (or lack thereof) of the contracts and evaluate whether the transactions have been entered into for an improper~~ purpose for the transaction or agreement;
- The terms of the contracts are consistent with management's explanations; and
- The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework

~~*A76A.The assumptions and data sources to which the accounting estimate is particularly sensitive are those which most influence estimation uncertainty in the method used and that have the greatest impact on the accounting estimate.*~~

Appropriateness of Management's Judgments in the Circumstances of the Entity (Ref: Para. 13B(a)(v~~i~~a))

A59O.*[To develop application material]*

Changes in Methods, Assumptions and Data (Ref: Para. 13B(a)(~~i~~vii))

A59P~~121I~~. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.

A59Q~~121J~~. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Inactive markets

A59R~~121K~~. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one ~~particular~~ model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.

~~*A121L. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.*~~

Management's Intent and Ability (Ref: Para. 13B(b))

A59S~~80~~. The reasonableness of the assumptions used 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 financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

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

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 assumptions reflect those used by marketplace participants.

~~A110. The auditor's considerations in relation to assumptions made by management and management's intent and ability are described in paragraphs A13 and A80.~~

Evaluating the Use of Models (Ref: Para. 13B(c))

A59T~~76~~. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:

- The model is periodically calibrated and tested for validity, particularly when assumptions are subjective.
- Adjustments are made to the output of the model, including in the case of fair value accounting estimates, whether such adjustments reflect the assumptions marketplace participants would use in similar circumstances.
- The model is adequately documented, including the model's intended applications and limitations and its key parameters, required assumptions, and results of any validation analysis performed.

[To align more closely with A25A]

[Subheading: Estimation Uncertainty] **(**Ref: Para. 13C~~(b)~~)

A59U~~8I~~. When evaluating the steps, if any, management has taken to address~~minimize~~ estimation uncertainty, the auditor may consider whether the method or model's design minimizes estimation uncertainty. In this regard, testing the operating effectiveness of controls that are intended to minimize estimation uncertainty may be useful.

Reasonableness of Management's Point Estimate or Range (Ref: Para 13C(a)(i))

A59V. *[To develop application material to provide guidance on when a management point estimate~~s~~ is reasonable and also when disclosures are 'adequate' (or a different term)]*

A59W~~58N~~. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A59X~~8O~~. When the auditor believes that the efforts of management are inadequate, the auditor may consider requesting management to consider alternative assumptions or to provide additional disclosure relating to the estimation uncertainty.

A59Y. [Application material to explain that the auditor may develop a point estimate or range in a variety of ways, including using management's model and flexing the assumptions, data sources, etc. and that the auditor may develop a point estimate or range over only part of the accounting estimate].

A59Z. [Application material to explain that, while it is common for the audit evidence to provide the auditor with the opportunity to narrow the range, in some cases the audit evidence may instead point to a wider range. This would imply a high level of estimation uncertainty, and may have implications for the auditor's report.]

Disclosures of Estimation Uncertainty for Accounting Estimates (Ref: Para 13C(a)(ii))

A60A~~58P~~. Even where the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate in light of the circumstances and facts involved. The auditor's evaluation of the adequacy of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraph A94).

A60B~~58Q~~. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. ISA 705 (Revised)[9] provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading. 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 (see ISA 701).

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

Management Point Estimate or Range Has Not Adequately Addressed Estimation Uncertainty (Ref: Para. 13C(b))

[To consider whether some parts of this section can be better placed under application material related to 13(a) → paragraph A59V-Z and A60B-E]

A60C. [Further application material may be warranted here]

A60D~~92~~. If, in the auditor's judgment, management has not adequately addressed the effect of estimation uncertainty, the ~~When the~~ auditor develops a point estimate or a range and uses assumptions or a method different from those used by management. ~~P, paragraph 13(d)(i) requires the auditor to~~ obtaining a sufficient understanding of the assumptions or method used by management in making the accounting estimate is important in evaluating management's point estimate. This is because ~~This~~ understanding management's assumptions or method provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

A60E~~87~~. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response where, for example:

- An accounting estimate is not derived from the routine processing of data by the accounting system.
- The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.
- The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.
- Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.
- There are alternative sources of relevant data available to the auditor which can be used in developing a point estimate or a range.

A60F~~88~~. Even where the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.

A60G~~89~~. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a preliminary point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, where possible, a point estimate.

A60H~~90~~. The ability of the auditor to develop a point estimate, as opposed to a range, depends on several factors, including the model used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range 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).

A60I~~91~~. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A60J~~91~~. The appropriate methods, data, and assumption to use depend on the requirements of the applicable financial reporting framework, and other factors. Obtaining an understanding of management's assumptions or methods aids the auditor evaluating management's point estimate in establishing that the auditor's point estimate or range takes into account relevant variables and enables the auditor in evaluating significant differences from management's point estimate.

~~Understanding Management's Assumptions or Method (Ref: Para. 13B(c))~~

Narrowing a Range (Ref: Para. 13C(b~~c~~))

A60K~~93~~. A range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.

A60L~~94~~. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, such as financial services or extractive industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk.

A60M~~95~~. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:

(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and

(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.

(c) Using an expert

(d) Considering whether alternative data or assumptions are more relevant and reliable than those selected by management (in light of the requirements of the applicable financial reporting framework) and, accordingly, if using of those alternative data or assumptions would result in an outcome that is within performance materiality

[Task Force to ~~fundamentally~~ further consider the important fundamental point of whether, and if so how, we link the range to performance materiality]

~~Narrowing a Range (Ref: Para. 13C(c)~~

~~A93. When the auditor concludes that it is appropriate to use a range to evaluate the reasonableness of management's point estimate (the auditor's range), paragraph 13(d)(ii) requires that range to encompass all "reasonable outcomes" rather than all possible outcomes. The range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.~~

~~A94. Ordinarily, a range that has been narrowed to be equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly in certain industries, it may not be possible to narrow the range to below such an amount. This does not necessarily preclude recognition of the accounting estimate. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk. Additional responses to significant risks are described in paragraphs A102–A115.~~

~~A95. Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:~~

~~(e) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and~~

~~(f) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.~~

~~A111. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:~~

- ~~Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.~~
- ~~It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.~~
- ~~It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.~~
- ~~Indicators of management bias in the making of accounting estimates may exist.~~

~~A112. The auditor's considerations in determining a range for this purpose are described in paragraphs A87–A95.~~