

ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures – Issues and Task Force’ Recommendations

Introduction

Background

1. The origins of this project lie in the IAASB’s Work Plan 2015–2016.¹ The IAASB assembled a Working Group to commence initial work on the special considerations in the audit of financial institutions (that is, banks and insurers). The original intention was that the IAASB would learn from this exercise and a project to revise International Standard on Auditing (ISA) 540 would follow, now fully informed of many of the more complex accounting estimate issues that arise in financial institutions and the perspectives of key stakeholders. The IAASB discussed issues related this initiative in March, June, and September 2015, and the IAASB Consultative Advisory Group (CAG) discussed the initiative in September 2015.
2. In response to representations by the Basel Committee on Banking Supervision’s Accounting Experts Group, the Working Group noted that there was an urgent and immediate need for guidance on auditing IFRS 9² estimates, particularly for financial institutions.
3. In September 2015, the IAASB decided that, rather than focusing on financial institutions first, the Working Group should instead focus on revising ISA 540 more broadly. This was because the IAASB saw that making significant progress on the special audit considerations for financial institutions, and providing material related to IFRS 9, would be difficult without concurrently revising ISA 540. This larger project was given priority and allocated additional staff, ISA 540 Task Force (the Task Force) members, and resources.
4. The project proposal to revise ISA 540 was approved at the IAASB’s December 2015 meeting. In the subsequent 9 months, the Task Force has:
 - Drafted and released a project publication to specifically address the audit implications of IFRS 9, particularly regarding the adoption of expected credit loss accounting. This publication, while non-authoritative, provided the IAASB’s views on the emerging issues around the adoption of IFRS 9 and expected credit loss accounting more broadly (including some references to the Financial Accounting Standards Board’s (at the time) forthcoming Current Expected Credit Loss model). It also highlighted the likely direction of the project to revise ISA 540 to support auditors in discussing their expectations about the information they would require and the adequacy of the entity’s information systems in the context of their prospective audits of the entity’s expected credit loss estimates.
 - Conducted over 20 outreach activities with stakeholders including regulators, auditors, financial institutions, and other types of entities.
 - Had six physical Task Force meetings and numerous teleconferences to progress issues.
5. As was acknowledged when the project proposal was approved, the Task Force’s intention is to ask the IAASB to approve an exposure draft (ED) in December 2016. This is an accelerated timetable

¹ International Financial Reporting Standard 9, *Financial Instruments*

² www.ifac.org/system/files/publications/files/IAASB-ISA-540-Project-Publication.pdf

and represents a significant commitment by the IAASB to attempt to issue a final revised ISA 540 to coincide with the effective date of IFRS 9.

The Task Force's Approach to Drafting Proposed Revised ISA 540

6. Due to the rapid pace of Task Force discussions, the Task Force has focused on the most critical issues within ISA 540. These issues were determined based on the extensive outreach conducted for this project – which gives the Task Force confidence that the right issues are being addressed. The various issues identified in outreach touch upon almost all areas of the ISA and have necessitated a significant rewrite of the standard.
7. The Task Force has come to a consensus on many aspects of the ISA. Other areas of the ISA are still being explored and the responses received on the proposals presented in these papers are critical to the Task Force being able to finalize the ISA in accordance with the planned approval of the ED. The level of Task Force engagement and consensus on each area is described in the relevant sections below. The Task Force acknowledges that there is still work to be done to achieve consistent language and terminology throughout the ISA, resolve some key issues (particularly regarding the work effort) and reorganize and adjust the application material.
8. **Agenda Item 2-B** shows marked changes from extant ISA 540. **Agenda Item 2-C** is a clean version of the same document. The discussion will follow **Agenda Item 2-B**.

Structure of this Paper

9. This paper is organized as follows:
 - Section I: Introduction to ISA 540, including Scalability of the ISA.
 - Section II: Objective and Definitions.
 - Section III: Risk Assessment.
 - Section IV: Work Effort.
 - Section V: Other Matters, Including Amendments to Other ISAs.

Section I – Introduction to ISA 540, Including the Scalability of the ISA

10. Only limited changes have been made to the introductory paragraphs of ISA 540 to align with minor wording changes related to the definition of an accounting estimate (see Section II below). Changes have also been made in view of the Task Force's recommendation to focus the auditor's work on accounting estimates on the implications of three factors (estimation uncertainty, complexity, and judgment) instead of just estimation uncertainty as is the case in extant ISA 540. The Task Force believes that, when present, these factors can give rise to higher risks of material misstatement relating to estimates. For a detailed discussion of these factors, and how they impact the risk assessment requirements, see Section III.
11. The Task Force has also continued to refine how the ISA deals with lower risk accounting estimates. Noting the calls for greater specificity in various aspects of the ISA by some stakeholders, there is a perception that a revised ISA with more, or more detailed, requirements could be disproportionate for audits that only have accounting estimates that give rise to lower risks of material misstatement (such as may be common for depreciation, doubtful debts of trade debtors etc.). Outreach with the International Federation of Accountants' Small and Medium Practices (SMP) Committee, and

discussions in the June 2016 Board meeting, highlighted the importance of scalability of ISA 540 for SMPs. The IAASB asked the Task Force to explore ways to be more specific about which aspects of the ISA do not apply to such accounting estimates.

12. The Task Force considered a number of ways to address this concern. The Task Force noted that it is not possible to make broad statements about the risks arising from accounting estimates for entities of different sizes – that is, even small entities can have accounting estimates that give rise to higher risks of material misstatement. This may occur, for example, if a small entity holds a complex financial instrument. Accordingly, the Task Force determined that the approach needed to be based on the nature and extent of risks arising from the accounting estimate, not on the size or nature of the entity that has the accounting estimate in its accounts.

New Approach to Dealing with the Entity's Accounting Estimates as a Whole, Individual Accounting Estimates, and Risks Arising From Individual Accounting Estimates

The Task Force has decided that clear language is needed to distinguish whether a requirement is aimed at the entity's accounting estimates as a whole, at individual estimates, or in response to specific risks of material misstatement arising from individual estimates. This hierarchy is distinguished in the drafting of the requirements, as is as follows:

- The accounting estimates as a whole are given the label “the accounting estimates_s” (plural). This is used in the risk assessment paragraphs (paragraphs 8-10A of **Agenda Item 2-B**)
- An individual accounting estimate is given the label “the accounting estimate” (singular). This is used in many of the work effort paragraphs (see, for example, paragraphs 12 and 12B of **Agenda Item 2-B**).
- A risk of material misstatement arising from an individual estimate is called “the risk of material misstatement” and may be further distinguished by terms such as “lower risk” and “other than lower risk.” This is used in certain work effort paragraphs which are intended to address the specific risks of material misstatement, such as paragraph 12A and 13 of **Agenda Item 2-B**.

This use of language will be explained in the application material to ISA 540 as well.

Proposed Approach to Enhance Scalability of the ISA

13. The Task Force considered whether additional application material added throughout the ISA would be sufficient to explain how the requirements may be applied to lower risks of material misstatement arising from accounting estimates. The Task Force rejected this approach as it would be complex to explain and may not resolve underlying concerns about the volume and appropriateness of requirements when dealing with such lower risks.
14. It was noted that a key component of addressing accounting estimates was understanding what risks arose from the accounting estimates. The auditor cannot assume that the risks of material misstatement arising from the accounting estimate are lower unless appropriate risk assessment procedures are performed. Accordingly, the Task Force concluded that all accounting estimates should be subject to the same risk assessment procedures (see paragraphs 8–10A of **Agenda Item 2-B**) so that appropriate responses can be designed and performed that are responsive to the risks of material misstatement that are present.

15. The benefit of a strong risk assessment is that the work effort, informed by an appropriate risk assessment, can be more specific and precise in addressing the actual risks of material misstatement arising from the accounting estimate – rather than the four option approach described in extant paragraph 13 of ISA 540. The Task Force proposes that the auditor be required to respond in accordance with ISA 330³ to the risks of material misstatement that are assessed as lower risk but not to mandate more specific procedures as is done in ISA 540. For those risks of material misstatement that are assessed as lower risk, the auditor is not required to comply with paragraph 13 through 16A of **Agenda Item 2-B**.
16. Under this approach, lower risks (e.g. those that commonly arise from simpler accounting estimates) are explicitly carved out from the more granular aspects of the work effort requirements, instead leaving these to be governed only by the general requirements set out in other ISAs (such as ISA 330 and ISA 500).⁴ For those auditors who would appreciate more guidance on possible procedures to address such risks, the work effort requirements in ISA 540 and the associated application material could be applied, adapted as necessary in the circumstances.
17. The advantages of this approach are that ISA 540 (Revised) can deal proportionately with lower risks without undermining the more specific work effort required for the higher risks. Lower risks result from corresponding lower degrees of estimation uncertainty, complexity, and judgment and, accordingly, share little in common with the risks that ISA 540 is primarily intended to address – that is, the risks that need a more specific and detailed approach. The Task Force believes that permitting such risks to be addressed in accordance with the remainder of the ISAs will also allow a broader range of audit procedures to be applied. The Task Force believes that this approach is consistent with the calls from stakeholders noted through the outreach activities.
18. The Task Force does not believe this approach will result in undue cost or burden. It could also be argued that not addressing the work effort on such risks in ISA 540 may result in lower risks not being adequately addressed (even though they will remain subject to other ISAs, including ISA 330, as is the case for risks arising from other financial statement items). The Task Force does not accept this argument as: (a) as these are lower risks and are correspondingly less likely to result in a material misstatement and ISA 540 is not specifically designed to address such lower risks; and (b) the auditor is still required to obtain sufficient appropriate audit evidence about such risks – the difference is in the specificity of the requirements to obtain the audit evidence.
19. In one area, the Task Force did see particular merit in additional application material specific to audits of smaller entities. The Task Force considered the implications of the new internal control requirement in paragraph 8A of **Agenda Item 2-B** (drawn from ISA 315 (Revised)).⁵ See also paragraphs 29–33 below) and was of the view that it would be useful to explain how these requirements affect the audits of small entities. The Task Force added application material (paragraph A38C and A38D) which highlights that the entity's internal control relevant to making accounting estimates within smaller entities is likely to differ from larger entities. The Task Force was of the view that internal control in smaller entities may use less structured means, simpler processes and procedures but also noted that management, or the owner-manager, is often closely involved in the operations. Through this

³ ISA 330, *The Auditor's Responses to Assessed Risks*

⁴ ISA 500, *Audit Evidence*

⁵ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

involvement management, or the owner-manager, may be able to exercise more effective oversight of the estimation process.

Matter for IAASB Consideration

1. Does the IAASB agree with the Task Force's intended approach of dealing with scalability, and more specifically with addressing lower risks of material misstatement arising from accounting estimates differently from other risks with respect to the work effort requirements? (see paragraph 12A of **Agenda Item 2-B**)

Section II: Definitions

20. In its June 2016 meeting, the IAASB suggested to simplify the definitions and further suggested that some of the proposed definitions may be better placed in the application material and that other definitions could be simplified by including further explanations to support these definitions in the application material.
21. Based on the discussion in the IAASB, the Task Force was of the view that the proposed new definitions may be better placed in the application material as (a) overly precise definitions may cause more difficulties in practice, and (b) it is easier to explain the difference between the terms in application material, such as the difference between method and model and the difference between data and assumptions. The application material can also include examples that may clarify the IAASB's thinking. The Task Force therefore added application material to requirement 8 to explain what is meant by the terms:
 - "Method" and "model", including the difference between the two terms (Paragraph A23A of **Agenda Item 2-B**);
 - "Data", including a description of the difference between factual data and derived data, the different sources of data, and examples of data (Paragraph A26A–A26B of **Agenda Item 2-B**); and
 - "Assumptions", including examples of assumptions and a paragraph that explains that it may not always be clear whether a particular item is data or an assumption (Paragraph A26E–A26G of **Agenda Item 2-B**).
22. Based on deliberations within the Task Force and comments received from the Board, the Task force furthermore enhanced the application material to the existing definitions (Paragraph A11B–A11E of **Agenda Item 2-B**) by adding further explanations and clarifications.

Accounting Estimate

23. The Task Force has sought to simplify the definition of an accounting estimate and better align some of the terminology with that used in IFRS. When extant ISA 540 was developed, one of the major features of the standard was that it combined two older standards, one dealing with accounting estimates and the other addressing fair value measurements and disclosures. In light of this feature, much of the definition of an "accounting estimate" is concerned with making clear that the definition includes fair value accounting estimates. As this is well understood in practice now, the Task Force believe that this material can be reduced and relocated to the application material.

24. The Task Force has also added application material (see paragraph A11B of **Agenda Item 2-B**) that clarifies that the definition includes accounting estimates in disclosures and accounting estimates used to make a judgment about whether to recognize or disclose an amount.

Matter for IAASB Consideration

2. The IAASB is asked for its views on:
- (a) The changes made to the existing definitions and the new application material related to these definitions; and
 - (b) The decision to explain the “method,” “model,” “data,” and “assumptions” through application material to paragraph 8 of **Agenda Item 2-B**.

Section III: Risk Assessment

25. The Task Force presented a first draft of the risk assessment section of ISA 540 to the Board in its June 2016 meeting. As the Board was generally in favor of the increased level of granularity in the risk assessment requirements and application material, the Task Force continued with this approach.
26. The main changes to the risk assessment paragraphs since the IAASB’s June 2016 meeting relate to:
- Breaking up paragraph 8 into two paragraphs; paragraph 8 which describes the auditor’s procedures with respect to obtaining an understanding of the entity’s environment and paragraph 8A of **Agenda Item 2-B** which describes the auditor’s procedures with respect to obtaining an understanding of the entity’s internal control;
 - Introducing paragraph 9A of **Agenda Item 2-B**, which requires the auditor to assess whether specialized skills or knowledge, in relation to one or more aspects of the accounting estimates, are required in order to perform the risk assessment and related activities;
 - Require the auditor to determine whether reviewing previous accounting estimates will assist the auditor in identifying and assessing risks of material misstatement in the current period;
 - Including new application material relating to the entity’s risk assessment process over accounting estimates and adding considerations specific for smaller entities and public sector entities; and
 - Enhancing the application material based on comments received and further discussions in the Task Force related to models, data and assumptions.

The Entity and Its Environment (Paragraph 8)

The Nature of the Accounting Estimate and Related Disclosures

27. Paragraph 8(aA) of **Agenda Item 2-B**, which is based on ISA 315 (Revised) paragraph 11, requires the auditor to obtain an understanding of the nature of the accounting estimates and the related disclosures to be expected in the financial statements. Discussions in the Task Force highlighted that the application material could be enhanced to better clarify how the auditor could obtain such an understanding. The Task Force was of the view that the auditor may obtain an understanding of the nature of the accounting estimate through the following matters:

- Understanding of the industry in which the entity operates;
- Understanding of the applicable financial reporting framework;
- Past knowledge and experience obtained through other audits and education; and
- Previous experience with the entity.

The Task Force will further consider adding further clarity on these aspects to cover an understanding of the entity and its operations/business model.

28. In addition to the changes above the Task Force made the following changes to paragraph 8 of **Agenda Item 2-B**:

- As a response to comments from the Board, simplified the introduction to improve the readability and clarity of the requirement.
- Enhanced the application material with respect to data (Paragraph A26A-A26D of **Agenda Item 2-B**) by adding the different sources of data and by improving the flow of the paragraphs included in this section.

The Entity's Internal Control (Paragraph 8A)

29. In the June 2016 meeting, some Board members suggested combining or re-ordering the new requirements in paragraphs 8(d), 8(e) and 8(f) of **Agenda Item 2-B** in order to improve the readability and clarity of the risk assessment paragraph. Some Board members were also of the view that the construct of paragraph 8 was complex and that breaking the paragraph up could improve its readability. As a response the Task Force discussed several approaches:

- Leave the structure as is and make incremental changes based on the suggestions made by the Board. This would be perhaps the simplest answer, but would not be responsive to the calls from the Board for greater clarity and simplification.
- Split paragraph 8 of **Agenda Item 2-B** into two requirements: requirement 8, which describes the procedures related to understanding the entity and its environment and requirement 8A, which describes the procedures related to understanding the entity's internal control and lists out all components of internal control. This split is similar to the split in ISA 315 (Revised).
- Combine the components of internal control into one bullet and add that bullet to requirement 8. This may result in losing the granularity of the auditor's understanding necessary to inform the auditor's risk assessment towards, which the Task Force has been working

30. The Task Force was almost unanimously of the view that it would be best to address the Board's concerns and the information obtained from outreach by drafting a new requirement (paragraph 8A of **Agenda Item 2-B**) and related application material. This paragraph requires the auditor to obtain an understanding of the components of internal control relevant to accounting estimates:

- The control environment;
- The entity's risk assessment process;
- The information system;
- The control activities; and
- The entity's activities to monitor controls.

31. However, it was also noted that the inclusion of all components of internal control in the requirement could be seen as repetitive as the components of internal control are already included the ISA 315 (Revised) and the description of the components in paragraph 8A is not specifically related to accounting estimates.
32. As a response to the comments received in the June 2016 Board meeting, the Task Force also made changes to the wording of paragraph 8A(a) of **Agenda Item 2-B** and the related application material. It was noted that under a two-tier model the supervisory board may not approve the individual accounting estimates since this is done by management. The Task Force was therefore of the view that adding 'if applicable' would be useful. Additionally, the Task Force enhanced the requirement by making clear that those charged with governance are responsible for the oversight of making the accounting estimates. One Task Force member questioned if the review and approval of the accounting estimate by those charged with governance should be included as part of the control environment since it could be seen as an activity.
33. In addition to the changes above, the Task Force made the following changes to paragraph 8A of **Agenda Item 2-B**:
 - The Task Force recognizes the importance of scalability (see section I) for SMPs and therefore considered the implications of the new internal control requirement and the related application material for SMPs. The Task Force was of the view that it would be useful to explain how this requirement affects the audits of small entities and added application material (paragraph A38C and A38D) that highlights how the entity's internal control relevant to making accounting estimates within smaller entities may differ from larger entities and directs the auditor to the considerations specific to smaller entities in ISA 315 (Revised).
 - The Task Force noted that the application material as presented to the Board for its June 2016 meeting covered many of the components of internal control except the risk assessment. The Task Force therefore added application material with respect to this component of internal control including guidance on what the objectives of the risk assessment process are for making accounting estimates.
 - Throughout the section, the Task Force made changes to the application material to make it more specific to accounting estimates.

Matters for IAASB Consideration

3. The IAASB is asked for its views on:
 - The changes made to paragraph 8 of **Agenda Item 2-B** and the related application material
 - Whether paragraph 8A related application material is sufficiently specific for accounting estimates;
 - Whether there are areas where application material could be added.
 - The structure of paragraph 8A.

Retrospective Review (Paragraph 9)

34. Extant ISA 540 describes the retrospective review of prior period accounting estimates. Under the extant ISA 540, the auditor is required to review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period.
35. Discussion in the Task Force indicated that there are a variety of views on when to perform the retrospective review and the Task Force therefore discussed ways to make this clearer in the requirements and the application material. Based on its deliberations, the Task Force was of the view that:
- For some accounting estimates, the retrospective review might not assist the auditor in identifying and assessing the risks of material misstatement in the current period. For example, for fair value accounting estimates, there is no observable outcome as the fair value determined at the reporting date will never be observed. In these circumstances the Task Force was of the view that a retrospective review should not be mandated.
 - In other circumstances, a retrospective review of previous accounting estimates may assist the auditor in identifying and assessing the risks of material misstatement, for example:
 - When the accounting estimates have an outcome through transfer or realization of the asset or liability; or
 - When the accounting estimates are re-estimated for the purpose of the current period (such as may be the case with accounting estimates that exist beyond a single financial reporting period).
 - A retrospective review could be performed over several financial reporting periods or over a shorter period, such as half-yearly or quarterly, in addition to the retrospective review over the prior period as required by extant ISA 540. The Task Force therefore changed the wording 'prior period accounting estimates' to 'previous accounting estimates' in the requirement and had previously already included paragraph A42a of **Agenda Item 2-B** in the application material.

Auditor's Use of an Expert (Paragraph 9A)

36. As noted in the July 2016 paper for the IAASB Teleconference, a revision of ISA 620⁶ is outside the scope of the project to revise ISA 540. However, the Task Force will consider recommending limited conforming amendments to ISA 620 as well as additional application material in ISA 540 where needed.
37. One of the areas where the Task Force was of the view that application material would be useful is in the risk assessment section. The Task Force discussed areas where using the work of an auditor's expert could be emphasized and recognized that some accounting estimates require the use of specialized skills to properly perform risk assessment procedures and related activities. The Task Force was of the view that the decision whether or not to engage an auditor's expert in performing risk assessment procedures and related activities depends on the experience and knowledge of the engagement team and the nature of the accounting estimate. The Task Force included its thinking in

⁶ ISA 620, *Using the Work of an Auditor's Expert*

paragraph 9A and added related application material in paragraph A44C – A44H of **Agenda Item 2-B**.

38. Currently paragraph 9A of **Agenda Item 2-B** does not require the auditor to assess whether specialized skills or knowledge are required in order to properly identify and assess the risk of material misstatement for accounting estimates, over and above the need for specialized skills or knowledge in performing other risk assessment procedures. The Task Force will discuss whether such an extension of requirement 9A would be useful.

Matter for IAASB Consideration

4. The IAASB is asked for its views on:
- (a) The changes made to the retrospective review;
 - (b) Whether the new requirement in paragraph 9A of **Agenda Item 2-B** to assess whether an auditor's expert needs to be engaged in order to perform risk assessment procedures and related activities and whether it would be useful if paragraph 9A includes an assessment whether the use of specialized skills or knowledge would be needed for the process of identifying and assessing the risks of material misstatement.

Identifying and Assessing the Risks of Material Misstatement (Paragraph 10 and 10A)

39. In its June 2016 meeting, the Board generally supported the factors⁷ in paragraph 10 that the auditor, at a minimum, should consider when identifying and assessing the risk of material misstatement and determining whether any of the risks identified are significant risks. Given the Task Force's desire to continue to explicitly link the work effort requirements to the factors in paragraph 10 of **Agenda Item 2-B** and to rationalize and simplify the proposed work effort requirements, the Task Force has consolidated the six factors previously presented into the following three overarching factors:
- Estimation uncertainty, which is reflected in the sensitivity of the accounting estimate to particular data, assumptions and methods that could be used;
 - Complexity, which is reflected in a need for a multiplicity of inter-related factors or processes in making the accounting estimate; and
 - The extent to which the use of management judgment is required, which reflects a degree of ambiguity or vagueness as to what is required in making the accounting estimate.
40. In extant 540, the extent and nature of estimation uncertainty is an important factor in identifying and assessing the risk of material misstatement. In their respective March 2016 meetings, the IAASB and IAASB CAG were of the view that estimation uncertainty is an important factor to consider in determining the risks of material misstatement when auditing accounting estimates. The Task Force

⁷ In its paper for the June 2016 IAASB meeting the Task Force included the following factors: (a) The extent to which the accounting estimates depend on subjective judgment, including assumptions; (b) The extent to which the accounting estimates are subject to high estimation uncertainty; (c) Whether the accounting estimates are based on data, from internal or external sources, that is unobservable, from outside the general and subsidiary ledgers, difficult to obtain or complex; (d) The complexity in making the accounting estimates, including the extent to which the method used to calculate an accounting estimate uses complex modelling or uses large volumes of data; (e) whether the accounting estimates are based on complex legal or contractual terms; or (f) The sensitivity of the accounting estimates to changes in particular data and assumptions.

therefore retained this factor. Estimation uncertainty is an inherent feature of an estimate that reflects an underlying inability to make the estimate with certainty. It excludes uncertainty that is within the control of management.

41. The outreach conducted by the Task Force and discussion with the IAASB CAG and the IAASB has consistently pointed to auditing challenges posed by highly complex accounting estimates. In particular, such complexity is reflected in the challenges that arise from the use of large volumes of data, complex models, complex assumptions or complex IT systems and in the difficulty in obtaining relevant and reliable data. In their respective March 2016 meetings, the IAASB and IAASB CAG were of the view that complexity in making the accounting estimate is an important factor to consider in determining the risks of material misstatement when auditing accounting estimates and the Task Force was therefore of the view that this factor should be considered.
42. Lastly, the Task Force was of the view that the use of judgment is important to add as it plays an important role in making accounting estimates since management has to select, for example, appropriate methods and assumptions or relevant and reliable data sources. The need for management judgment may create an opportunity for management bias (whether intentional or unintentional) to occur.
43. The Task Force discussed how the factors included in paragraph 10 differ from each other and was of the view that they may be interrelated but all come from a different angle. Risks of material misstatement related to estimation uncertainty is an inherent feature of an accounting estimate and cannot be reduced. Estimation uncertainty may arise due to the environment or industry in which the entity operates, for example because of the volatility in jurisdictions or markets or the requirements of the applicable financial reporting framework. The risks of material misstatement arising from complexity in making the accounting estimate may come from the entity's business or structure, the requirements of the applicable financial reporting framework, or the entity's internal controls. The risk of material misstatement related to judgment may come from the decisions about the courses of action that, according to management, are appropriate in preparing the financial statements such as the selection of particular assumptions, models or data
44. In addition to the factors included in paragraph 10 of **Agenda Item 2-B**, paragraph A46 of **Agenda Item 2-B** includes other relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement, including determining whether any of those risks are significant risks.
45. The Task Force also added application material to revised paragraph 10 that:
 - Explains how the factors differ from each other (paragraph A44F of **Agenda Item 2-B**);
 - Explains the interrelationships between the factors (paragraph A44G of **Agenda Item 2-B**); and
 - Provides examples of the sources of risks of material misstatement that arises from estimation uncertainty, the use of judgment and the complexity in making the accounting estimates.

Identification of Accounting Estimates with Lower Risk of Material Misstatement (Paragraph 10A)

46. In the response to the risk of assessment section in ISA 540, the Task Force added paragraph 12A of **Agenda Item 2-B** that requires the auditor to respond, in accordance with ISA 330, to the risks of

material misstatement that are assessed as lower risk. For these accounting estimates, the auditor is not required to comply with paragraphs 13 through 16A of **Agenda Item 2-B**.

47. Extant ISA 540 requires the auditor to assess the risk of material misstatement but there is no requirement to assess the risk of material misstatement as lower (or higher) other than determining significant risks. Since this assessment is important in applying paragraph 13 of **Agenda Item 2-B**, the Task Force considered that a new requirement was needed (Paragraph 10A of **Agenda Item 2-B**) for the auditor to make an assessment as to whether an accounting estimate has a lower risk of material misstatement. The Task Force included related application material that provides guidance on whether an accounting estimate may be assessed as having a lower risks of material misstatement. These preliminary factors identified are being further considered by the Task Force and may include:
- Routine, non-complex calculations that are subject to systematic processing and control;
 - Little or no estimation uncertainty; and
 - Minimal judgment by management over the selection of appropriate data and assumptions.

Matters for IAASB Consideration

5. The IAASB is asked for its views on:
- (a) The factors identified for identifying and assessing the risks of material misstatement, being estimation uncertainty, complexity, and judgment; and
 - (b) New paragraph 10A of **Agenda Item 2-B** that requires the auditor to assess whether or not the risk of material misstatement is lower risk.

Section IV – Work Effort

Background

48. At the June 2016 IAASB meeting, the IAASB discussed the Task Force's initial thinking regarding the ISA 540 work effort. In brief, the discussion centered on the following matters:
- (a) Whether events occurring after the balance sheet date could resolve or address the lack of measurement precision that is the distinguishing characteristic of accounting estimates – meaning that other procedures would not be required under ISA 540 to obtain sufficient appropriate audit evidence. This may occur in some limited circumstances, such as when the resolution of a legal matter provides strong evidence about a legal liability.
 - (b) The merits of a principles-based work effort requirement, complemented by more detailed requirements to address specific circumstances.
 - (c) Whether conditional requirements would be valuable in addressing specific risks – such as having a requirement to perform a specific procedure (or a set of procedures, or to choose procedures from a list) whenever a specific risk is present.
 - (d) The Task Force's initial drafting of a possible “stand back” requirement at the conclusion of the work effort. This requirement is intended to drive the auditor to take into account all the evidence obtained, whether corroborative or contradictory, and conclude whether the auditor has sufficient appropriate audit evidence regarding accounting estimates with high estimation

uncertainty or high complexity. This requirement is at a more detailed level than the requirement in ISA 700 (Revised),⁸ paragraph 13(c), to evaluate whether, in view of the requirements of the applicable financial reporting framework, the accounting estimates are reasonable.

49. In broad terms, there was some support for the idea of a principles-based requirement as it allows for innovation over time to address evolving risks and circumstances, but also some concerns that it may not lead to additional work being performed. There was also some resistance to the level of detail indicated in the procedures – perhaps due to the drafting and also perhaps indicative of a need for simplification. The core concern was that overly detailed required procedures would be challenging as some do not believe that the Board will be able to identify and describe the appropriate responses to all the potential risks that might be identified.

Approach Included in Agenda Item 2-B

50. The Task Force has continued to consider various alternatives to a revised work effort. The latest drafting developed by the Task Force is included in paragraphs 11A–16A of **Agenda Item 2-B**. As noted in paragraph 7 above, the Task Force has discussed the work effort on several occasions but has not fully agreed on the draft wording to be used, nor has the application material been fully developed to support the revised requirements.
51. The approach to the work effort shown in **Agenda Item 2-B** that the Task Force has focused on is described below, and a flowchart illustrating how it functions is shown in the Appendix:
- (a) Paragraph 11A: Consideration of whether the auditor requires specialized skills or knowledge in order to obtain sufficient appropriate audit evidence. This procedure follows immediately after the auditor's assessment of risk, meaning that the auditor is considering whether specialized skills and knowledge are needed to perform any or all of the work effort requirements. This paragraph was in extant ISA 540 (as paragraph 14), but was relocated by the Task Force as it was seen to be sufficiently important that it needed to come earlier in the ISA. Paragraph A44F of **Agenda Item 2-B** provides a bridge to ISA 620, and whether an auditor's expert is needed.
 - (b) Paragraph 12: This paragraph has not changed significantly from extant ISA 540. It contains two specific procedures which are of particular importance to the audit of accounting estimates – both of which are based on the risk of material misstatement (that is, the higher the risk, the more persuasive the evidence required). The first procedure is to determine whether management's method appropriately applies the requirements of the applicable financial reporting framework relevant to the accounting estimate. The second procedure is to determine whether management's methods for making the accounting estimate are appropriate and has been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.
 - (c) Paragraph 12A: As discussed in Section I above, this procedure bifurcates the work effort. For lower risks, the auditor is directed to respond in accordance with ISA 330 but is not required to perform the procedures in paragraphs 13–16A. Such procedures may, however, be useful guidance in responding in accordance with ISA 330.

⁸ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

- (d) Paragraph 13: This is the key work effort requirement in ISA 540 for risks other than lower risks. The work effort requirement in extant ISA 540 provides four options of procedures to perform. By contrast, the work effort requirements in revised paragraph 13 are specifically identified as being responsive to the nature of the assessed risks of material misstatement that result from the factors described in paragraph 10. These factors are estimation uncertainty, complexity, and judgment (see Section III above). To date, the Task Force has only had time for preliminary discussions about the detailed wording of this paragraph and is continuing to consider how best to refine its construction. In doing so, the Task Force is considering: the nature of the assessed risks that each factor gives rise to and the extent to which these are unique or overlap with such risks for other factors; the appropriate procedures to respond to these risks; and the extent to which such procedures should be mandated in particular circumstances or the auditor is required to apply judgment as to which is the appropriate procedure to apply in the circumstances. The current wording in the draft revised standard reflects the early thinking, as described below, but the Task Force will be exploring how to develop this further.
- i. Importantly, the Task Force has focused on the need to ensure that risks other than lower risks are appropriately responded to. Of particular concern has been the perception from some stakeholders that, currently, few significant risks⁹ are determined to exist and that auditors focus the majority of the work effort on those significant risks – with the practical effect that other risks that are high (or, as some firms would say “elevated”), but are not significant risks, do not receive enough of the auditor’s attention. This has been a focus of the Task Force since early in the project, and the Task Force proposes that paragraph 13 should explicitly link the nature, timing and extent of procedures to be performed to the assessed risks of material misstatement, recognizing that the higher the risk, the more persuasive the audit evidence needed. The Task Force has liaised with the ISA 315 (Revised) Working Group in this regard.
 - ii. The Task Force intends that the revised paragraph 13 will have more detailed and focused requirements that better support and require high quality audits. Paragraph 13 does this by requiring the auditor’s responses to the assessed risks to include the procedures in paragraph 13, unless another procedure is, in the auditor’s professional judgment, more responsive to the assessed risks (this is supported by a documentation requirement in paragraph 23 of **Agenda Item 2-B** to avoid the risk that this is misused). This may also address the concern noted above that the more detailed or specific the requirements, the more difficult it is for the IAASB to address all possible circumstances.
 - iii. The major visual change to paragraph 13 is the use of a table to avoid the need to repeat procedures that are responsive to more than one of the factors from paragraph 10. The table lists procedures in order of their relevance to the following three broad areas: data and assumptions, management’s method for making the accounting estimate, and developing an auditor’s point estimate or range. In columns next to each of the procedures are ticks to indicate which of the factors in paragraph 10 the procedure is intended to address. Some procedures, of course, are broad and may cover all three. Other procedures are more narrowly targeted and may only cover one or two factors. The Task Force has sought to break some of the procedures in extant paragraph 13 into

⁹ ISA 315 (Revised) defines a significant risk as “An identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.”

more detail so that the requirement is more explicit about what the procedure entails, thereby better linking the procedures to the nature of the risks it is intended to address. However, the Task Force recognizes that there are inter-relationships between the various factors and is continuing to consider whether the apparent overlap in the application of the requirements can be eliminated by more clearly explaining these inter-relationships and more clearly distinguishing what is different about the impact of each factor in terms of giving rise to risks of material misstatement.

- iv. As the application material supporting paragraph 10 (paragraphs A44I–A49F of **Agenda Item 2-B**) includes a non-exhaustive list of the risks of material misstatement that may arise from each of the factors, the auditor's determination of which procedures to apply is informed by the auditor's understanding of the nature of the risk of material misstatement as it relates to the factors in paragraph 10.
 - v. For risks of material misstatement, other than lower risks dealt with by paragraph 12A, that do not arise from the factors in paragraph 10, the auditor needs to choose an appropriate procedure from the table that responds to the assessed risk, unless another procedure is more responsive to the assessed risk..
 - vi. The Task Force has had only limited discussions about the way the procedures in the table are articulated, and whether all of the procedures are required for each factor. It is acknowledged that further work needs to be done to consider differentiating some of the procedures (or perhaps combining some), adding supporting application material, or making some of the procedures mandatory.
- (e) Paragraph 13A: This paragraph contains conditionally mandatory procedures addressing the use of models, testing the operating effectiveness of controls, and evaluating management's intent to carry out specific courses of action. Some Task Force members believe more specific or stronger requirements are needed on models and internal control – this will be further discussed by the Task Force.
 - (f) Paragraphs 14 and 15 of the extant ISA: These paragraphs address specialized skills and knowledge, and some specific procedures related to significant risks. They have been relocated to paragraph 11A and paragraph 13, respectively. With respect to paragraph 15, the Task Force noted that there was nothing in their wording that made these procedures appropriate only for significant risks. In response to the Task Force's concern that higher risks (that are not significant risks) may not be given the appropriate auditor attention, the requirements of paragraph 15 have been moved to paragraph 13 to make them applicable to all risks arising from accounting estimates, other than lower risks (which are dealt with in accordance with ISA 330).
 - (g) Paragraph 16: This paragraph is focused only on estimation uncertainty related to significant risks and requires the auditor, if considered necessary, to develop a range with which to evaluate the reasonableness of the accounting estimate. The Task Force has not focused on this requirement yet, but has noted that the words "if considered necessary" may serve to undermine the intent of the requirement.
 - (h) Paragraph 16A: This is the proposed "stand back" requirement at the conclusion of the work effort discussed in paragraph 48(d) above.

52. The Task Force will continue to explore the changes needed to the work effort and will take into account the discussions at the September 2016 IAASB and IAASB CAG meetings. It is expected that the Task Force will discuss, amongst other matters which procedures should be mandatory, conditionally mandatory (that is, mandatory if a given condition is met – such as a risk of material misstatement related to a complex model) or optional.

Matters for IAASB Consideration

6. What views does the IAASB have on the work effort requirements (paragraphs 11A–16A of **Agenda Item 2-B**)? Specific comment is sought regarding:
- (a) The lead-in to paragraph 13, including the focus on the nature of the risks rather than on the individual accounting estimate.
 - (b) The focus on risks other than lower risks, rather than focusing more on the defined term “significant risks.”
 - (c) How much should the requirements be mandatory (including when a specific factor giving rise to a higher risk is present) versus the extent to which the ISA should require the auditor to use judgment to determine the most effective procedures to respond to the risk?
 - (d) The clarity of the link between the factors in paragraph 10 and the procedures listed in the table in paragraph 13.
 - (d) The use of a table in paragraph 13 to list the procedures to be performed.
 - (e) The “stand back” requirement in paragraph 16A.
 - (f) Any other matter discussed in this section.

Significant Risks

53. In addition to the discussion in paragraphs 51(f) and (g) above, the Task Force notes that some IAASB members supported the idea that the intensity of response could vary for significant risks, rather than mandating certain specific procedures (regardless of why the risk was deemed to be a “significant risk”) as is done in extant ISA 540. It was also suggested that:
- (a) The auditor’s response to significant risks could require the involvement of more experienced employees – perhaps not specifically the engagement partner but an appropriately senior and experienced member of the engagement team.
 - (b) While contradictory evidence will always need to be taken into account, the auditor may have a greater need to look more closely at contradictory evidence for significant risks.
54. As noted above, the Task Force continues to develop this area, and does not have specific proposals to share in relation to these suggestions as yet.

Section V – Other Matters, Including Amendments to Other ISAs

Interactions with the Professional Skepticism Working Group

55. Recognizing the importance of the work of the Professional Skepticism Working Group to the revision of ISA 540, there continues to be active liaison between the two groups. At the June 2016 IAASB

meeting, the Professional Skepticism Working Group presented recommendations¹⁰ to the IAASB regarding ISA 540. In broad terms, these recommendations were:

- Restructuring of certain requirements to emphasize the importance of addressing inconsistent audit evidence.
- To mandate discussions amongst the engagement team about the accounting estimates that represent risks due to a high level of estimation uncertainty inherent to the estimate, the absence or insufficiency of internal controls around the estimate, or the existence of potential indicators of management bias surrounding the estimate.
- In the risk assessment section, consider more explicitly “what could go wrong.”
- Describe in ISA 540 how documentation may assist auditors in making judgments requiring professional skepticism.
- Specific suggestions with respect to the work effort requirements and application material, including how to respond if management disagrees with the material misstatements identified by the auditor.

The Professional Skepticism Working Group also supported a number of initiatives already under consideration by the Task Force, including the stand back requirement in paragraph 16A and reinforcing material addressing management bias,

56. At the conclusion of the June 2016 IAASB meeting, the Task Force reported back to the IAASB on its initial discussion on these recommendations and noted the following:
- Some recommendations had been dealt with already by the Task Force, but that the detailed thinking of the Professional Skepticism Working Group would inform further deliberations.
 - The Task Force noted a number of places in the ISA where alternative wording suggested by the Professional Skepticism Working Group could be used (i.e. “contradicts”/“inconsistent” or “challenge”/“question”). However, the Task Force had some concerns that this would not change auditor behavior, as it was not clear what the auditor would be required to do differently, nor how the auditor will be able to document the different actions.
 - With regards to the discussion amongst engagement team members, the Task Force expressed some concerns that it may not be suited to smaller audits. The Task Force noted that it was worth considering whether the same objective can be accomplished by different means.
57. As the Task Force had a heavy workload over the period June-September, the Task Force has not explicitly returned to these points at the present time. However, the points have been noted by the Task Force and have informed some of the Task Force discussions.
58. In relation to the broader application of professional skepticism in ISA 540, it has been noted by some Task Force members that the term “reasonable” is used in key places in the ISA, particularly with regard to the auditor’s assessment of assumptions and the development of an auditor’s range estimate. These members are concerned that the term “reasonable,” even with the application material in paragraph A78 of **Agenda Item 2-B**, does not give the appropriate amount of direction to the auditor on what needs to be done in response and an alternative term such as “appropriate” may

¹⁰ http://www.iaasb.org/system/files/meetings/files/20160621-Agenda_Item_2-A-Professional_Skepticism_Issues-Paper.pdf

be preferable, as is used elsewhere in ISA 540. Other Task Force members have noted that sometimes the term “reasonable” is the best term, as the financial reporting framework may not be specific about how to calculate the accounting estimate, or the estimate may be difficult to measure due to estimation uncertainty, complexity, or judgment.

Reporting Implications

Background

59. A significant change in the ISAs since the current version of ISA 540 was drafted is the revised auditor’s report, including the communication of key audit matters. Accounting estimates often require significant auditor attention and the new possibility of communicating key audit matters may assist auditors in communicating directly with users.

Selected Paragraphs from ISA 701 (Emphasis Added)

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).⁵ (Ref: Para. A19–A22)
 - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)...
- A23. ISA 260 (Revised) requires the auditor to communicate with those charged with governance the auditor’s views about significant qualitative aspects of the entity’s accounting practices, including accounting policies, accounting estimates and financial statement disclosures.²⁷ In many cases, this relates to critical accounting estimates and related disclosures, which are likely to be areas of significant auditor attention, and also may be identified as significant risks.
- A24. However, users of the financial statements have highlighted their interest in accounting estimates that have been identified as having high estimation uncertainty in accordance with ISA 540²⁸ that may have not been determined to be significant risks. Among other things, such estimates are highly dependent on management judgment and are often the most complex areas of the financial statements, and may require the involvement of both a management’s expert and an auditor’s expert.

60. As the IAASB was well aware that accounting estimates often require significant auditor attention, ISA 701¹¹ includes references to accounting estimates in key places. The box above this section highlights some of the key references to accounting estimates in ISA 701.
61. The IAASB also made conforming amendments to ISA 540 as a result of the auditor reporting project. Additional application material was added to paragraph A114 to draw attention to the communication of key audit matters in the auditor’s report:

A114. With respect to accounting estimates that have not been recognized, the focus of the auditor’s evaluation is on whether the recognition criteria of the applicable

¹¹ ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

financial reporting framework have in fact been met. Even where an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. Where applicable, the auditor may also determine that an accounting estimate that has been identified as having a high estimation uncertainty is a key audit matter to be communicated in the auditor's report in accordance with ISA 701, or may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report (see ISA 706 (Revised)).¹² If the matter is determined to be a key audit matter, ISA 706 (Revised) prohibits the auditor from including an Emphasis of Matter paragraph in the auditor's report.¹³

Task Force Recommendation

62. The Task Force believes that ISA 701, and the amendments to ISA 540, collectively set appropriate requirements and provide adequate guidance with respect to the new key audit matters section of the auditor's report. Accordingly, staff propose only a minor amendment to ISA 701 to bring it into line with the new focus on the complexity of accounting estimates and the judgment involved thereon in ISA 540:

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised).⁵ (Ref: Para. A19–A22)
 - (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty, complexity, or depend on significant management judgment. (Ref: Para. A23–A24)
 - (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

63. In relation to ISA 540, an additional reference to ISA 701 is proposed to paragraph A123 of **Agenda Item 2-B**. The Task Force will consider whether further guidance is needed, but do not expect to make major changes.

¹² ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

¹³ ISA 706 (Revised), paragraph 8(b)

Matter for IAASB Consideration

7. Does the IAASB support the proposed changes to ISA 540 and ISA 701 described above?

Communication with Those Charged With Governance and Regulators

Communication with Those Charged With Governance

64. ISA 260 (Revised)¹⁴ contains specific material regarding communications with those charged with governance. Currently, paragraph 16(a) of ISA 260 (Revised) contains the following accounting-estimate specific material:

The auditor shall communicate to those charged with governance...[t]he auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, which is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity;

65. IAPN 1000¹⁵ also refers to communication with those charged with governance. It notes that because of the uncertainties associated with the valuation of financial instruments, the potential effects on the financial statements of any significant risks are likely to be of governance interest. Of the matters listed in IAPN 1000,¹⁶ the following may be most suitable for inclusion in ISA 540 as matters for communication to those charged with governance:

- (a) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
- (b) The relative materiality of the accounting estimates to the financial statements as a whole;
- (c) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates, particularly financial instruments;
- (d) Significant deficiencies in the internal control or risk management systems relating to accounting estimates;
- (e) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to valuations performed by management or a management's expert;
- (f) Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
- (g) The auditor's views about the appropriateness of the selection of accounting policies and presentation of financial instrument transactions in the financial statements;
- (h) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for financial instruments; and

¹⁴ ISA 260 (Revised), *Communication with Those Charged With Governance*

¹⁵ International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

¹⁶ IAPN 1000, paragraph 143–144

- (i) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the measurement uncertainty associated with financial instruments.
66. The above matters have been included in **Agenda Item 2-B** as paragraphs 22A and A127A and have been adapted as necessary to reflect the broader scope of ISA 540 compared to IAPN 1000.

Communication with Regulators

67. During the outreach activities conducted by the Task Force, it was noted that effective two-way communication between the auditor and a financial institution's regulator (with or without the presence of management) is key to the respective roles of the auditor and the regulator.
68. ISA 540 currently has no references to communications with a regulator. IAPN 1000 has application material as follows:

In some cases, auditors may be required,¹⁷ or may consider it appropriate, to communicate directly with regulators or prudential supervisors, in addition to those charged with governance, regarding matters relating to financial instruments. Such communication may be useful throughout the audit. For example, in some jurisdictions, banking 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, and compliance with regulations. This coordination may be helpful to the auditor in identifying risks of material misstatement.

69. In light of the importance of financial institution audits, the Task Force proposes that an amended version of this material be included as application material in ISA 540 (see paragraph A127B of **Agenda Item 2-B**). It is acknowledged that this will not be sufficiently detailed for financial institutions with mandatory communications with regulators, however this is best dealt with via an appropriate IAPN, rather than in ISA 540 that applies to all audits.

Matter for IAASB Consideration

8. Does the IAASB support new paragraphs 22A and A127A–A127B of **Agenda Item 2-B**?

Documentation

70. In the course of the ISA 540 outreach activities, it was noted that documentation of the auditor's work regarding accounting estimates was important for a number of reasons:
- Adequate documentation identifies the judgments made by the auditor and the rationale for those judgments. This is particularly necessary when the accounting estimate requires management to make subjective judgments; and

¹⁷ For example, ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires that, if the auditor has identified or suspects non-compliance with laws and regulations, the auditor shall determine whether law, regulation or relevant ethical requirements require the auditor to report to an appropriate authority outside the entity, or to establish responsibilities under which reporting to an appropriate authority outside the entity may be appropriate in the circumstances.

- Inspection findings¹⁸ have noted that accounting estimates have given rise to a number of identified audit deficiencies. Clear documentation requirements will assist auditors in demonstrating the exercise of professional skepticism, the judgments made and procedures performed and will better support inspectors in conducting audit inspections and focusing on the sufficiency of and appropriateness of audit evidence obtained in the audit.
71. The Task Force proposes amendments to paragraphs 23 and A128 of **Agenda Item 2-B**. These amendments, together with ISA 230,¹⁹ are intended to require additional documentation of :
- (a) The rationale for the auditor's judgment to use, or not to use, an auditor's expert when dealing with accounting estimates with high estimation uncertainty, high judgment, or high complexity;
 - (b) How the auditor addressed the indicators of management bias;
 - (c) The basis for how the auditor demonstrated professional skepticism in auditing the accounting estimates, including relevant matters related to the auditor's overall conclusions about the reasonableness and appropriateness of the accounting estimates, and their disclosure, and the significant professional judgments made by the auditor regarding accounting estimates with high estimation uncertainty, high complexity, or that depend on judgment.
 - (d) When the auditor has performed other procedures that are more responsive to the risk of material misstatement (see paragraph 13), a description of the other procedures and the auditor's rationale for why they are more responsive to the identified risk. (Ref: Para. A128)

Matter for IAASB Consideration

9. Does the IAASB support the proposed changes to paragraph 23 and A128?

Insurance Contracts

72. One area that the Task Force has noted warrants investigation is the upcoming Insurance Contracts accounting standard. The Task Force received a briefing from representative of the IASB regarding the upcoming Insurance Contracts standard. In the presentation, the following areas were noted as being areas of key judgments:
- Probability weighted estimates of expected cash flows
 - Based on expectations of behavior;
 - Claim events (hurricanes, death);
 - Investment returns for participating contracts (especially if guaranteed)
 - Discount rates that
 - Reflect the characteristics of the cash flows of the insurance contract
 - Are consistent with observable current market prices

¹⁸ See, for example, page 2 of the 2013 International Forum of Independent Audit Regulators Survey of Inspection Findings (www.ifiar.org/IFIAR/media/Documents/IFIARMembersArea/MemberUpdates/IFIAR-Inspection-Survey-9-April-2014_1.pdf) or pages 2-3 of the 2014 Survey (www.ifiar.org/IFIAR/media/Documents/General/About%20Us/IFIAR-2015-Survey-of-Inspection-Findings.pdf)

¹⁹ ISA 230, *Audit Documentation*

- Risk adjustment
 - Level of aggregation based on similar risks and profitability
 - Applying the standard for the first time
73. The Task Force notes that the key judgment areas were consistent with the Task Force's current thinking regarding other complex estimates (such as expected credit losses and complex financial instruments), and that some guidance may be warranted to draw attention to those matters. The Task Force added a relevant insurance example to paragraph A3 of **Agenda Item 2-B**. This approach is consistent with the treatment of expected credit losses.

Matter for IAASB Consideration

10. Are there areas of the ISA where material related to insurance contracts should be added?

External Data Sources

36. In its July 2016 Teleconference the IAASB discussed the Task Force's preliminary thinking with respect to the use of external assistance by management and the auditor. Due to the need to focus on other aspects of ISA 540, specifically the work effort requirements, the Task Force has not discussed the auditor's use of external data sources further at this time. This will be a topic for discussion in Q4, 2016.

Appendix

Illustration of How Revised Work Effort Operates for Differing Levels of Risk

