

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

1. Since the September 2016 IAASB meeting the Task Force had one physical meeting and two teleconferences at which the comments received from the IAASB and the IAASB Consultative Advisory Group (CAG) were discussed.
2. The main topic of discussion in the physical Task Force meeting was the work effort for accounting estimates. In light of the IAASB's comments, the Task Force continued with its efforts to link the work effort to the enhanced risk assessment procedures that have been developed when dealing with accounting estimates. Consistent with the paper presented to the IAASB in September 2016, the risk assessment continues to be based on a more focused effort to identify the reasons for the risk of material misstatement. The Task Force believes that the factors of estimation uncertainty, complexity, and judgment drive the risk for most accounting estimates, but accepts that there could be other risk factors in specific circumstances.
3. The Task Force will continue its discussions on the work effort in its next physical Task Force meeting in November and will present an updated work effort section to the Board for discussion at the December 2016 meeting, including revised work effort proposals for simple accounting estimates (see paragraph 16).
4. This issues paper includes the discussion on the following topics that the Task Force also discussed during its last physical meeting:
 - Considerations relative to the use of the word "reasonable" (Section I);
 - The threshold for when further specific procedures are required (Section II);
 - Requirements for accounting estimates that give rise to significant risks (Section III); and
 - The updated requirements related to disclosures (Section IV).

Section I: The Use of the Word "Reasonable"

5. At its September 2016 meeting, the Board noted that the use of the word "reasonable" in the objective of the standard should be considered by the Task Force as it was questioned whether "reasonable" is a sufficiently high threshold. Similar concerns were raised by some of the Task Force members in previous Task Force meetings. In light of these comments, the Task Force considered the usage of the term throughout ISA 540.
6. In addition to the objective, the term "reasonable" is used in the requirements and application material of extant ISA 540 relating to:
 - (a) Assumptions used by management (paragraph 13(b)(ii) and paragraph 15(b) – matters the auditor may consider in evaluating the reasonableness of assumptions are listed in paragraph A78 and there are related references in 15(c) and in A79, A80, A81, A83 and A107);
 - (b) Developing a range (paragraph 13(d)(ii) and paragraph 16, with related references in A93, A94 and A95);

- (c) Evaluating the accounting estimate (Paragraph 18, with related references in A118 and A119); and
 - (d) Management representations (Paragraph 22).
7. Given the subjective nature of the word reasonable, the Task Force was of the view that the use of the term “reasonable” may not adequately promote, and could undermine, the exercise of professional skepticism. The Task Force noted that whether something is reasonable, or not, depends on someone’s viewpoint and that it does not necessarily mean that this is the most likely outcome. For example, some view that the term “reasonable” is intended to mean either “in accordance with the applicable financial reporting framework” or, alternatively, “not unreasonable”.
 8. In previous Task Force discussions, specific concerns were also expressed about the use of the word reasonable in the application material to paragraph 13(b)(ii) in extant ISA 540. This paragraph deals with the reasonableness of assumptions, and it was noted that it could be seen as being circular, in that the word “reasonable” is used in the first bullet, which states “Matters that the auditor may consider in evaluating the reasonableness of the assumptions used by management include, for example: Whether individual assumptions appear reasonable...”
 9. The Task Force also noted that, when developing a range to evaluate management’s point estimate, the range of “reasonable” outcomes of accounting estimates may be wider than performance materiality. In such circumstances, some Task Force members noted that it is not evident how such a wide range would be meaningful in evaluating management’s point estimate, though it may be more relevant in evaluating disclosures about measurement uncertainty.
 10. The Task Force discussed several options for a way forward with respect to the use of the word reasonable, including:
 - Linking the threshold more clearly to the relevant requirements of the applicable financial reporting framework; and
 - In some places, either deleting the word reasonable where it is not deemed necessary to use such a qualifier, or replacing it with another term such as “appropriate” or “acceptable”.
 11. The Task Force also briefly considered defining “reasonable” for purposes of ISA 540, but was of the view that this could be confusing given that the word is used throughout the ISAs in different contexts.
 12. Where appropriate, the Task Force was supportive of moving away from using the word “reasonable”, recognizing that the difference between “appropriate” and “acceptable” is subtle. In that respect it was noted that, in some languages, “appropriate” and “acceptable” are translated into the same word and it was suggested only to use one of those terms. The Task Force also recognized that replacing the term “reasonable” with another term might not affect the auditor’s approach to auditing accounting estimate, while linking the term, where possible, to the relevant requirements of the financial reporting framework may do so.
 13. To date, the Task Force has avoided use of the word “reasonable” in some places, preferring alternatives such as “appropriate,” which has sometimes been paired with “in light of the applicable financial reporting framework.” The Task Force also considered excluding the term in the objective (see proposed drafting below). With respect to the other paragraphs in ISA 540 where the word “reasonable” is used, the Task Force will develop suggestions for how the term can be addressed.

14. In the box below, the Task Force has included an example of how the objective section of ISA 540 could look by refocusing the objective on compliance with the applicable financial reporting framework by removing the word “reasonable”.

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:
- (a) accounting estimates, including fair value accounting estimates, recognized or disclosed in the financial statements, whether recognized or disclosed, are reasonable, and related disclosures, are in accordance with the requirements of the applicable financial reporting framework, and are free from bias in management’s judgments that could lead to a material misstatement; and
 - (b) related disclosures in the financial statements are adequate,
in the context of the applicable financial reporting framework.

Matters for IAASB Consideration

1. Does the IAASB support:
 - (a) The proposed wording of the objective; and
 - (b) The Task Force’s approach to the use of the term “reasonable” in general?

Section II: The Threshold for Further Specific Procedures

15. As noted in the draft minutes of the IAASB September 2016 meeting, the Task Force presented a revised work effort that included a threshold of “other than low” for the application of specific requirements to design and perform further audit procedures to respond to the assessed risks of material misstatement. In this regard, the assessment of risks of material misstatement takes into account the risk factors in proposed paragraph 10 of the ISA relevant to estimates: complexity, judgment, estimation uncertainty, and any other identified factors. During the discussion, it was questioned whether the reference to “other than low” in proposed paragraphs 13, 13A, 13B and 13C would put too much focus on the threshold instead of the characteristics of the assessed risks, and whether “other than low” should relate to the risk of material misstatement or to the risk factors.
16. After the IAASB’s September meeting, the leadership of the Task Force met with representatives of the Small and Medium Practices (SMP) Committee and the Federation of European Accountants (FEE) to discuss the revision of ISA 540. The discussions highlighted that both groups favor an explicit threshold in ISA 540 (Revised) that would result in simple accounting estimates not being subject to the detailed work effort requirements related to complexity, estimation uncertainty and judgment. The SMP Committee noted that an overarching principle in the International Standards is that the nature, timing, and extent of the procedures to be performed depends on the risk of material misstatement. However, while recognizing that audits of all entities are subject to ISA 540, many SMPs would support requirements that make the scalability of the International Standards clearer.
17. In light of the Board’s comments and those obtained through further discussions with the SMP Committee and FEE referred to above, during its physical meeting the Task Force further discussed the use of a threshold. The Task Force considered whether to:

- (a) Retain “other than low/lower”; or
 - (b) Reinforce the “spectrum of risk” concept in the application material but not include an explicit threshold.
18. Given the desire to target specific work effort requirements to identified risks of material misstatement that have been assessed as being other than low, and the importance of clarity regarding the work effort requirements for simpler accounting estimates, the Task Force concluded, on balance, that it would be helpful to include a threshold in the requirements. However, the Task Force noted that a threshold would not be capable of being applied in a highly precise manner, whether applied at an overall level in relation to the assessment of a risk of material misstatement or at the level of the factors giving rise to the risk. Therefore, the application material would reinforce that this is targeted at the lower end of the risk spectrum, not simply anything that was not a significant or “higher” risk. This would minimize the possibility that a risk of material misstatement could be inappropriately scoped out of the work effort by subjective interpretation of the threshold language. The Task Force also recognized that whatever the form of the threshold, application material would need to give very clear signals about the types of estimates that were and were not expected to be addressed.
19. The Task Force considered different options for the threshold and concluded that the choice of a word (“low” or “lower”) should be based on the Board’s assessment of which term better communicates the intended meaning. As noted by some Board members, the Task Force acknowledges that “low” is a more definitive term that may need to be defined and that “lower” (as noted above) can be interpreted as a relative term (e.g., lower than “higher” risk) – see also the next paragraph.
20. The Task Force also discussed whether the threshold should be directed at the risk of material misstatement (assertion) level or at the risk factor level. ISA 330¹ requires the auditor to design audit procedures that are responsive to the assessed risk of material misstatement at the assertion level, taking into account the reasons for the assessment given to a risk². Both ISA 330 and other ISAs also discuss the auditor’s response in the context of the assessed “level” of risk, including references to thresholds of “lower” or “higher” (though not thresholds of “low” or “high”) risks of material misstatement, for example:
- ISA 330, paragraph 7(b) and the related application material, refer to higher assessment of risk;³

¹ ISA 330, *The Auditor’s Responses to Assessed Risks*

² Paragraph A10 of ISA 330 states “*The reasons for the assessment given to a risk are relevant in determining the nature of audit procedures. For example, if an assessed risk is lower because of the particular characteristics of a class of transactions without consideration of the related controls, then the auditor may determine that substantive analytical procedures alone provide sufficient appropriate audit evidence. On the other hand, if the assessed risk is lower because of internal controls, and the auditor intends to base the substantive procedures on that low assessment, then the auditor performs tests of those controls, as required by paragraph 8(a).*”

³ Paragraph 7(b) of ISA 330 states “*In designing the further audit procedures to be performed, the auditor shall:...(b) Obtain more persuasive audit evidence the higher the auditor’s assessment of risk.*” Paragraph A19 states “*When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable, for example, by placing more emphasis on obtaining third party evidence or by obtaining corroborating evidence from a number of independent sources.*”

- ISA 701,⁴ paragraph 9(a) refers to “Areas of higher assessed risk of material misstatement” in the determination which matters that require significant auditor attention;⁵
 - The application material to ISA 315 (Revised) and ISA 330 includes several references to higher assessed risks of material misstatements.
21. Task Force members noted that the assessed risk of material misstatement is based on consideration of the underlying risk factors and agreed that the intention is for the auditor to consider whether specific risk factors (e.g., estimation uncertainty, complexity, judgment or other identified factors) are reasons for the assessment of a risk of material misstatement and to perform specific procedures that are directly responsive to those factors, in addressing the assessed risks of material misstatement at the assertion level. Some Task Force members believe that applying a threshold at the level of the factors could be contradictory to the concepts in ISA 315, by implying that the assessment of risks of material misstatement should be made at a lower level (factors) than the assertion level. Other members of the Task Force believe that applying a threshold at the factor level does not require a specific assessment of the impact of that factor on the risk assessment; rather, it requires a consideration of the level of complexity, uncertainty or judgment involved and whether those levels are low.
22. The table below provides an illustration of the introductory wording of the specific work effort requirement for just one of the three risk factors (in this case, complexity), and highlights the two options for the level at which the threshold could be applied (in both cases the word “low” is used, but is not intended to prejudge the views of the Board regarding the choice of word to describe the threshold). In either case, the risk assessment is undertaken at the assertion level and considers whether the factors are reasons for the assessment given to the risks:

[Note: underlined text is to emphasize key wording differences. Marked changes from the papers presented at the September 2016 IAASB meeting are not shown]

Option 1: Threshold at Risk of Material Misstatement Level

13A. In designing and performing further audit procedures in accordance with paragraph 13, if the assessed risk of material misstatement is other than low and the reasons for that assessment are due to complexity in making the accounting estimate, the auditor shall: (Ref: Para. A67B–67C)

Option 2: Threshold at Risk Factor Level

13A. In designing and performing further audit procedures in accordance with paragraph 13, if the reasons for the assessment given to the risk of material misstatement are due to other than low complexity in making the accounting estimate, the auditor shall: (Ref: Para. A67B–67C)

⁴ ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

⁵ Paragraph 9(a) of ISA 701 states “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 ⁵higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised). (Ref: Para. A19–A22).…”

Challenges Associated with Options 1 and 2

23. Under either Option 1 or Option 2, the challenge is in specifying the work effort at the right level, given that accounting estimates affected by complexity, estimation uncertainty, or judgment may have different levels of risk of material misstatement for a variety of reasons. For example, the risk of material misstatement of an accounting estimate may be assessed as “other than low” based on one, two, or all three of the factors. Alternatively, it is conceivable that the auditor may assess the risk of material misstatement at the assertion level as low even if the effect of one of the particular risk factors in making the assessment is considered other than low. This could be for different reasons:
- (a) For example, it could be because the auditor has identified a control over the complexity that is considered to be effective such that the combined or separate assessment of inherent and control risk results in an assessed risk of material misstatement that is low. The result would be that the specific procedures required by the revised work effort would not be triggered for that risk factor (complexity) under Option 1 (even though consideration would need to be given to performing tests of controls and/or substantive tests to obtain sufficient appropriate audit evidence. Under Option 2, the auditor would still be required to design and perform further audit procedures to address the complexity, even though the assessed risk of material misstatement is low.
 - (b) Alternatively, it could be because the complexity itself has a relatively insignificant effect on the making of the estimate. In these circumstances, the result would be that the specific procedures required by the revised work effort would not be triggered for that risk factor of complexity under either Option 1 or Option 2.
24. A perceived benefit of Option 1 is that the work effort to respond to estimation uncertainty, complexity or judgment is only required when the risk of material misstatement is assessed as other than low (having taken into account the extent to which those risk factors affect the assessed risk of material misstatement). When the assessed risk of material misstatement is other than low, the further procedures to respond are, however, still targeted at the reasons for the assessment given to the risk (i.e., the risk factors), consistent with ISA 330.
25. With respect to Option 2, the auditor is required to respond directly to an “other than low factor” e.g., complexity (the reasons for the assessment given to a risk of material misstatement). In this regard, and in contrast to Option 1, the auditor may be required to perform procedures to specifically respond to a risk factor that is “other than low” despite having a low assessed risk of material misstatement at the assertion level.

Matters for IAASB Consideration

2. The IAASB is asked for its views on:
- (a) Whether it supports the Task Force’s view that a threshold is needed in ISA 540;
 - (b) If so, whether Option 1 or Option 2, as presented above, is preferred for the articulation of the threshold; and
 - (c) If a threshold is to be applied, whether the word “low” or “lower” (supported by appropriate application material) is preferred.

Section III: Procedures to Respond to Significant Risks

26. Paragraphs 15–17 in extant ISA 540 (see below) include additional substantive procedures for accounting estimates that give rise to a significant risk. These procedures focus on addressing estimation uncertainty and the recognition and measurement for accounting estimates that give rise to a significant risk.

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330, the auditor shall evaluate the following: (Ref: Para. A102)
- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103–A106)
 - (b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107–A109)
 - (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)
16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111–A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:
- (a) Management's decision to recognize, or to not recognize, the accounting estimates in the financial statements; and (Ref: Para. A113–A114)
 - (b) The selected measurement basis for the accounting estimates, (Ref: Para. A115)
- are in accordance with the requirements of the applicable financial reporting framework.

27. The Task Force's discussions on the work effort requirements have focused on having procedures that are responsive to the nature of the risk. Accordingly, the procedures contained in extant paragraphs 15–17 have largely been incorporated, or will be incorporated, into the work effort requirements applicable to accounting estimates with certain risk factors. This is because these procedures are by their nature more generally applicable, and there is no clear reason for why they should only be required for significant risks. Unlike extant ISA 540, the implication of the not having specific procedures for significant risks is that they are no longer required to be performed unless the particular risk factor is present.
28. The Task Force also noted that extant paragraphs 15-16 are explicitly aimed at estimation uncertainty, and do not address risks arising from complexity or judgment. The Task Force was of the view that these requirements, and related application material, could be included under the auditor's work effort related to the risk factors "estimation uncertainty" or "judgment". With respect

to extant paragraph 17, the Task Force was of the view that it should be required for all accounting estimates. Paragraph 17(a) could be included as a separate bullet under paragraph 12 of extant ISA 540 and paragraph 17(b) was, in the Task Force's view, similar to extant requirement 12(a) and could be incorporated into that requirement.

29. In light of this, the Task Force discussed whether additional substantive procedures are still needed for accounting estimates that give rise to a significant risk. In these discussions the Task Force took into account comments made at the September 2016 IAASB meeting that the Task Force's proposed approach to the work effort has reduced the need for different procedures for accounting estimates that give rise to significant risks. In addition, the Task Force has sought to reinforce the underlying requirements in ISA 330 related to significant risks by including reference to this in proposed paragraph 13 of ISA 540 (Revised). This, together with the statement that the higher the risk, the more persuasive the audit evidence needed, is seen by the Task Force as providing a robust reminder to auditors on what work effort is required (whether tests of controls or substantive tests or a combination of both) is appropriate, depending on the nature, extent and likelihood of the assessed risks.
30. The Task Force was therefore generally of the view that no specific further procedures would be required for significant risks. By complying with the proposed work effort paragraphs, the assessed risks of material misstatement should have been sufficiently addressed, with the intensity of the auditor's response (that is, extent and timing of procedures) varying in response to the nature, extent and likelihood of the risk. Accordingly, the nature, timing and extent of the procedures to be performed for an accounting estimate that gives rise to a significant risk would be enhanced compared to an accounting estimate that has a risk of material misstatement that is other than low but is not a significant risk.
31. The Task Force was of the view that the reference to significant risks in revised paragraph 10 would be retained, so that reference can be made to significant risks in revised paragraph 13 and throughout the application material of ISA 540 (Revised).

Matter for IAASB Consideration

3. Does the IAASB support the Task Force's intention to not have specific incremental requirements for accounting estimates that give rise to significant risks beyond the required procedures in the work effort addressing estimates in general? If not, what procedures should be considered by the Task Force?

Section IV: Disclosures

32. In September 2016, the Task Force presented to the IAASB and the CAG its preliminary drafting with respect to disclosures related to accounting estimates.
33. The preliminary drafting included, in paragraph 19(b), a requirement for the auditor to obtain sufficient appropriate audit evidence whether the disclosures are adequate to enable users to understand the estimation uncertainty regarding accounting estimates recognized or disclosed in the financial statements even if the applicable financial reporting framework does not require the disclosure of estimation uncertainty. Concerns were noted by the IAASB and the CAG that this new requirement may be seen as imposing financial reporting requirements.
34. The Task Force discussed the comments received on this requirement and was of the view that this requirement is intended to require the auditor to consider whether the disclosures adequately cover matters that are important to investors and other users of the financial statements, and is similar to what is required by ISA 570 (Revised) with respect to going concern. This should reflect

the consideration of whether the financial statements achieve fair presentation (in the case of a fair presentation framework) or are not misleading (in the case of a compliance framework).

35. In recognition of the importance of disclosures in addressing estimation uncertainty, the Task Force decided to incorporate requirements addressing disclosure into the proposed work effort requirement related to estimation uncertainty. The disclosure requirement would therefore be a higher-level, principles-based requirement.
36. The Task Force considered how the auditor should deal with disclosures overall, and proposes the following changes to paragraph 19 of ISA 540:

19. ~~The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are:~~ to evaluate whether the accounting estimates have been appropriately disclosed in accordance with the applicable financial reporting framework and: (Ref: Para. A120–A123)
 - ~~(a) In the case of a fair presentation framework, the disclosures are appropriate to achieve fair presentation of the financial statements, or~~
 - ~~(b) In the case of a compliance framework, the disclosures are appropriate for the financial statements not to be misleading.~~
 - ~~(a) In accordance with the requirements of the applicable financial reporting framework; and (Ref: Para. A120–A121)~~
 - ~~(b) If the applicable financial reporting framework does not require disclosures of estimation uncertainty regarding accounting estimates (whether on the face of the financial statements or in the notes), adequate to enable users to understand the estimate uncertainty regarding accounting estimates recognized or disclosed in the financial statements.~~
20. The auditor shall also evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework. (Ref: Para. A122–A123)

* * *

Disclosures in Accordance with the Applicable Financial Reporting Framework (Ref: Para. 19)

A120. The presentation of financial statements in accordance with the applicable financial reporting framework includes adequate disclosure of material matters. The applicable financial reporting framework may permit, or prescribe, disclosures related to accounting estimates, and some entities may disclose voluntarily additional information in the notes to the financial statements. These disclosures may include, for example:

- The assumptions used.
- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained

about whether the disclosures are in accordance with the requirements of the applicable financial reporting framework.

A120A. Determining the nature, timing and extent of further audit procedures as they relate to disclosures is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures.

A121. In some cases, the applicable financial reporting framework may require specific disclosures regarding uncertainties. For example, some financial reporting frameworks prescribe:

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as “Key Sources of Estimation Uncertainty” or “Critical Accounting Estimates.”
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of information regarding the significance of fair value accounting estimates to the entity’s financial position and performance.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity’s objectives, policies and procedures for managing the risk and the methods used to measure the risk and any changes from the previous period of these qualitative concepts.
- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity’s key management personnel, including credit risk, liquidity risk and market risk.

[Note: The following two application material paragraphs are shown as deletions from only this section of the ISA. They have been incorporated into the work effort section addressing estimation uncertainty instead.]

~~Disclosures of Estimation Uncertainty for Accounting Estimates that Give Rise to Significant Risks (Ref: Para. 20)~~

~~A122. In relation to accounting estimates having significant risk, 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).~~

~~A123. 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. It may be the case that the auditor’s consideration of the adequacy of disclosures regarding estimation uncertainty is a matter that required significant auditor attention. In such cases, ISA 701 contains requirements and application material regarding the communication of key audit matters in the auditor’s report. ISA 705 (Revised)⁶ 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.~~

⁷ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

A121A. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the disclosures, represent the underlying transactions and events in a manner that achieves fair presentation. Depending on the facts and circumstances, given the importance of accounting estimates to the overall financial statements, the auditor may determine that additional disclosures related to accounting estimates are necessary to achieve fair presentation. This may be the case, for example, when an accounting estimate is subject to significant estimation uncertainty (see paragraphs AXX-AXX above).

37. These changes are intended to:

- Require auditors to evaluate whether the disclosures regarding accounting estimates are in accordance with the requirements of the applicable financial reporting framework and, in the case of a compliance framework, are not misleading. In the case of a fair presentation framework, given the importance of disclosures to accounting estimates, the Task Force believes it is important that the auditor considers whether there are further disclosures that should be made to avoid the auditor being associated with misleading information. In this regard, the Task Force's proposal is consistent with paragraph 20 of ISA 570 (Revised), which states "the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide adequate disclosures about these events or conditions."
- Provide application material that highlights that the nature, timing and extent of audit procedures as they relate to disclosures is important in light of both the wide range of information and the level of detail that may be encompassed in those disclosures. This is similar to paragraph A12a of ISA 330 as revised in the IAASB's Disclosures project.
- Remind the auditor that, when the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation includes the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

Matter for IAASB Consideration

4. Does the IAASB support the changes proposed to paragraph 19-20 of ISA 540?

Draft Minutes from September 2016 IAASB Meeting

Note: the minutes below have yet to be reviewed by the Task Force Chair and Co-Chair and are subject to change.

ISA 540⁷

Mr. Sharko and Mr. Pickeur introduced the topic by highlighting the feedback received by the CAG and the anticipated timeline for 2016.

DEFINITIONS

In general, the Board was supportive of the changes made by the ISA 540 Task Force (Task Force) to the existing definitions, including the new application material, and the decision to explain the “method,” “model,” “data,” and “assumptions” through application material to paragraph 8 of ISA 540. Among other matters, the Task Force was asked to consider whether a definition of “lower risk” would better delineate the treatment of lower risk accounting estimates from other types of estimates, and whether an alternative definition for ‘accounting estimate’ would capture non-monetary estimates.

RISK ASSESSMENT

The Board generally noted support for the risk assessment requirements but asked the Task Force to consider the following matters:

- Paragraph 8A, which describes the five components of internal control, could be seen as duplicative as it repeats the factors that are included in paragraph A58 of ISA 315 (Revised). However, the Board also noted that a reference back to ISA 315 (Revised) would be useful, as well as application material to the paragraph. It was also questioned whether all five factors would be relevant for accounting estimates and the Task Force was asked to focus on which components of internal control require specific attention for accounting estimates.
- The reference to ‘the review and approval of the accounting estimates, by those charged with governance’ in paragraph 8A(a), could be interpreted as a control activity. The Task Force was asked to explain the involvement of those charged with governance in the application material.
- It was questioned how the auditor would obtain an understanding of how management has addressed estimation uncertainty as required by paragraph 8(c)(iv).
- With respect to the retrospective review, it was questioned whether changing the review from ‘prior period’ accounting estimates to ‘previous’ accounting estimates is clear, as it could lead to differing interpretations. It was also noted that the retrospective review has an inherent risk that hindsight will be involved. It was therefore suggested that the application material could clarify that for certain accounting estimates, such as an Expected Credit Loss provision, the practitioner should not over rely on the retrospective review.

⁷ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- Paragraph 9A could be clarified with a direct reference to the use of an auditor's expert and ISA 620.⁸
- The Board was supportive of increasing the scalability in ISA 540 by excluding simple accounting estimates from the work effort requirements, but the criterion used ("lower risk") in paragraph 10A was seen as potentially confusing, particularly as it was not clear what quantum of risks comprised the "lower" risks. It was also noted that the requirement could focus the auditor's attention on the threshold and quantifying the risk instead of focussing on the characteristics of the assessed risks of material misstatement.

The Board concluded that the reference to both inherent and control risk in paragraph 10 should be included in the application material instead of the requirement because the assessment of whether an accounting estimate gives rise to a significant risk is based on inherent risk alone. As this assessment is included in the sentence before, referring to both inherent and control risk in the subsequent sentence could lead to incorrect interpretations. It was also noted that addressing both inherent risk and control risk in a requirement pre-empts the project to revise ISA 315 (Revised), which covers the relationship between inherent and control risk and the discussion about whether significant risk should be based on inherent risk alone. However, some Board members were of the view that including a reference to control risk was important given the importance of controls in developing some accounting estimates.

WORK EFFORT

The Board discussed the work effort as included in **Agenda Item 2-B** and noted the following matters:

- The Board was of the view that referring back to ISA 330⁹ for accounting estimates that are assessed as having a "lower risk" may fail to provide adequate direction and guidance for auditors who encounter such estimates, because ISA 330 does not include specific guidance on how the auditor should address accounting estimates. Others noted that the reference to ISA 330 could be seen as circular because ISA 540 builds on ISA 330. Some Board members were of the view that scalability should be included in ISA 315 (Revised) or ISA 330, while others were of the view that ISA 540 should include scalable requirements with respect to all accounting estimates. The Board suggested that further application material would be useful to explain the Task Force's intentions and to highlight that the scalability of the work effort is driven by the characteristics of the accounting estimate.
- The introduction to paragraph 13 could be seen as contradictory because the first sentence requires the auditor to perform procedures as listed in the requirement, while the second sentence provides the auditor with the option to perform other procedures when these are more responsive to the assessed risk.
- The work effort requirement as presented in paragraph 13 of **Agenda Item 2-B**, was seen by some Board members as not supporting a principles-based approach. Board members had mixed views about the table setting out the procedures, noting that that it is not clear what the tick marks indicate, that the detailed procedures could create a checklist mentality and that it may set a precedent for future International Standards.

⁸ ISA 620, *Using the Work of an Auditor's Expert*

⁹ ISA 330, *The Auditor's Responses to Assessed Risks*

- The Board was of the view that the stand-back requirement should be mandatory for all accounting estimates, but that the stand back requirement should be more extensive for more difficult accounting estimates.
- With respect to accounting estimates that give rise to a significant risk, it was noted that the Task Force's approach had reduced the need for different procedures for significant risks.

The Task Force presented a revised work effort as included in **Supplement to Agenda Item 2**.

The Board commented as follows:

- The Board was generally supportive of the direction taken by the Task Force noting that the structure was improved and more intuitive. It was noted that further work should be done to integrate the risk factors in paragraph 10 into the work effort requirements.
- Several Board members were of the view that the last sentence of paragraph 13¹⁰ should be moved to the first sentence as it highlights the overarching principles of the work effort. By moving it to the first sentence the remainder of paragraph 13 could elaborate on the auditor's work effort over the risk factors of complexity, estimation uncertainty and professional judgment.
- It was questioned whether the reference to 'other than low' in paragraph 13, 13A, 13B and 13C would put too much focus on the threshold instead of the characteristics of the assessed risks, and whether the "other than low" should relate to the risk of material misstatement or to the risk factors of complexity, judgment, and estimation uncertainty.
- With respect to paragraph 13D, the Task Force was asked to consider changing the requirement to make clear that the auditor does not need to search for procedures that are more responsive than those specified in the requirements.

OTHER MATTERS

The Board discussed the other matters set out in Section V of **Agenda Item 2-A** and noted the following:

- With respect to the new requirement to communicate matters that arose from the auditor's work on accounting estimates to those charged with governance, the Board noted that it could be clarified by explaining which matters should be communicated. The related application material that highlights that the auditor may also communicate matters with regulators or prudential supervisor was also supported.
- The Board was of the view that no conforming amendments to ISA 701¹¹ or other auditor reporting standards should be made until the IAASB has completed the post-implementation review on the new auditor reporting standards.
- The Board made several suggestions to enhance the documentation requirement, including that:
 - Some may interpret paragraphs 23(a) as requiring the auditor to engage an auditor's expert for every accounting estimate with high estimation uncertainty, high judgment or high complexity. It was suggested that the requirement could focus on documenting whether or not the auditor has the right level of skills and expertise.

¹⁰ The nature, timing and extent of procedures to be performed shall be responsive to the assessed risks of material misstatement, recognizing that the higher the risk, the more persuasive the audit evidence needed.

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

- Some Board members noted that the standard as drafted does not include requirements that explicitly refer to professional skepticism and, therefore, the documentation requirement on the use of professional judgment (paragraph 23(c)) does not clearly link back to another procedure. The importance of coordination with the Professional Skepticism Working Group was also highlighted in this regard.
- With respect to paragraph 23(d), it was noted that it was unclear if this requirement would apply when the auditor performed some, but not all, of the procedures listed in paragraph 13. Furthermore, it was unclear whether the requirement would apply when the risk of material misstatement is other than low because of a risk factor other than complexity, judgment and estimation uncertainty and the auditor therefore did not perform any of the procedures in paragraph 13.
- It was noted that the standard could benefit from some more insurance industry specific examples in the application material.

IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron highlighted that the CAG is very supportive of this project and the direction it is going. He also noted that the CAG understands that it will be difficult to complete this project on time given the amount and difficulty of the work, and the interplay with other IAASB projects. With respect to the table setting out the procedures, he noted that the CAG was generally of the view that it was too prescriptive and questioned whether such a table would set a precedent for other standards.

WAY FORWARD

Mr. Sharko and Mr. Pickeur explained the next steps that the Task Force will take, still targeting approval of an Exposure Draft at the IAASB's December 2016 meeting. They highlighted areas where the Task Force has not finalized its deliberations, including on some of the recommendations from the Professional Skepticism Working Group and the conforming amendments to ISA 500¹² for external data sources. The Board highlighted that the following areas should also be considered:

- The response when an accounting estimate has estimation uncertainty that is multiple times performance materiality. The Board noted that further application material in this area would be useful given the increased occurrence of such accounting estimates because of changes in accounting standards and the business environment.
- The use of the word 'reasonable' in the objective of the standard. It was questioned whether 'reasonable' is a sufficiently high threshold.
- Further guidance on auditing models, including highlighting when the auditor is required to obtain a detailed understanding of the model and when the auditor can audit around the model.
- Whether the Task Force could invite an experienced practitioner with an IT background to read through ISA 540 to confirm that the wording is aligned with the terminology used by IT specialists.

¹² ISA 500, *Audit Evidence*