

Basis for Conclusions
Prepared by the Staff of the IAASB
October 2018

International Standard on Auditing 540 (Revised)

Auditing Accounting Estimates and Related Disclosures

Including Conforming and
Consequential Amendments to
Other International Standards

IAASB

International Auditing
and Assurance
Standards Board

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The objective of the IAASB is to serve the public interest by setting high-quality auditing, assurance, and other related services standards and by facilitating the convergence of international and national auditing and assurance standards, thereby enhancing the quality and consistency of practice throughout the world and strengthening public confidence in the global auditing and assurance profession.

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants (IFAC).

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BASIS FOR CONCLUSIONS: ISA 540 (REVISED), AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES, INCLUDING CONFORMING AND CONSEQUENTIAL AMENDMENTS TO OTHER INTERNATIONAL STANDARDS¹

This Basis for Conclusions has been prepared by Staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, or the conforming and consequential amendments to other International Standards.

ISA 540 (Revised) and the conforming and consequential amendments to other International Standards were approved with the affirmative votes of 17 out of 18 IAASB members present for the vote at the June 2018 meeting.²

Introduction

Background

1. The project to revise ISA 540³ started with the IAASB consultations in developing its Strategy for 2015–2019: *Fulfilling Our Public Interest Mandate in an Evolving World*⁴ and related Work Plan for 2015–2016: *Enhancing Audit Quality and Preparing for the Future*.⁵ These consultations indicated a need for the IAASB to take action to address issues relevant to the application of ISA 540 in audits of financial institutions, as well as more broadly. In addition, findings from the IAASB's post-implementation review of the clarified ISAs⁶ indicated areas in which clearer or additional requirements or guidance were needed to enable auditors to appropriately deal with increasingly complex accounting estimates and related disclosures. The input from the IAASB's consultations, along with reports of inspection findings from audit regulatory bodies noting consistent issues with respect to auditing accounting estimates, highlighted this as a key area where enhanced standards were needed to drive improved audit performance.
2. Since early 2015, the IAASB has undertaken outreach activities to identify issues regarding the auditing of accounting estimates for financial institutions and other entities. The outreach indicated that regulators and auditors of financial institutions were of the view that the IAASB should focus on the issues for audits of financial institutions arising from IFRS 9,⁷ ahead of its effective date for financial statements for annual periods beginning on or after January 1, 2018, and a similar accounting standard-setting project being conducted by the United States Financial Accounting Standards Board. These standards adopt expected credit loss models for loan loss provisions, which

¹ The IAASB's International Standards comprise the International Standards on Auditing (ISAs), the International Standards on Review Engagements (ISREs), the International Standards on Assurance Engagements (ISAEs), and the International Standards on Related Services (ISRSs).

² For a full record of the voting on ISA 540 (Revised), including the rationale of the IAASB members who abstained from the vote, see <http://www.iaasb.org/system/files/meetings/files/Approved-IAASB-Public-Session-Minutes-of-the-Meeting-June-2018.pdf>.

³ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

⁴ https://www.ifac.org/system/files/publications/files/IAASB-Strategy-2015-2019_0.pdf

⁵ <https://www.ifac.org/system/files/publications/files/IAASB-Work-Plan-2015-2016.pdf>

⁶ These findings are discussed in the 2013 publication, *Clarified International Standards on Auditing-Findings from the Post-Implementation Review*.

⁷ International Financial Reporting Standard 9 (IFRS), *Financial Instruments*

fundamentally changes the way that banks and other entities will account for their loan assets and other credit exposures.

3. After considering the input from key stakeholders, including the IAASB Consultative Advisory Group, the IAASB concluded that most, if not all, of the issues identified with respect to expected credit losses would be equally relevant when auditing other complex accounting estimates. Accordingly, it was concluded that a holistic revision of ISA 540 should be undertaken as a matter of priority.
4. The IAASB approved a project proposal⁸ to revise ISA 540 in December 2015 with the following objectives:
 - Propose revisions to ISA 540, establishing more robust requirements and appropriately detailed guidance to foster audit quality by driving auditors to perform appropriate procedures in relation to accounting estimates and related disclosures. It is anticipated that these revisions would also seek to emphasize the importance of the appropriate application of professional skepticism when auditing accounting estimates.
 - Determine whether non-authoritative guidance and support tools, such as IAPNs,⁹ Staff publications,¹⁰ project updates or other materials, should be developed in the future to address special audit considerations relevant to financial institutions¹¹ to supplement the revisions to ISA 540 and oversee the development of the guidance material considered necessary.
5. The Task Force issued a project update¹² in early 2016 to summarize the audit challenges identified with respect to expected credit losses and set out initial thinking on how these challenges may be addressed under the current ISAs.
6. In its March 2017 meeting, the IAASB approved proposed ISA 540 (Revised)¹³ (ED-540) for public exposure, including related conforming and consequential amendments to other International Standards. ED-540 was issued on April 20, 2017 for comment by August 1, 2017. Comment letters were received from 69 respondents, including investors and analysts, those charged with governance, regulators and audit oversight authorities, national auditing standard setters, accounting firms, public sector organizations, preparers, International Federation of Accountants (IFAC) Member Bodies and other professional organizations, academics and individuals. Responses were received from four Monitoring Group members.¹⁴

⁸ <https://www.ifac.org/publications-resources/project-proposal-revision-isa-540>

⁹ IAPNs do not impose additional requirements on auditors beyond those included in the ISAs, nor do they change the auditor's responsibility to comply with all ISAs relevant to the audit. IAPNs provide practical assistance to auditors. They are intended to be disseminated by those responsible for national standards, or used in developing corresponding national material. They also provide material that firms can use in developing their training programs and internal guidance.

¹⁰ Staff publications are used to help raise practitioners' awareness of significant new or emerging issues by referring to existing requirements and application material, or to direct their attention to relevant provisions of IAASB pronouncements.

¹¹ For the purpose of the project proposal, financial institutions include banks and insurance companies.

¹² <https://www.ifac.org/publications-resources/isa-540-revision-project-publication>

¹³ ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

¹⁴ The Monitoring Group comprises the Basel Committee on Banking Supervision (BCBS), the European Commission, the Financial Stability Board, the International Association of Insurance Supervisors (IAIS), the International Forum of Independent Audit Regulators (IFIAR), the International Organization of Securities Commissions (IOSCO), and the World Bank. BCBS, IAIS, IFIAR, and IOSCO responded to ED-540.

*ISA 315 (Revised)*¹⁵

7. In 2016, the IAASB commenced a project to revise ISA 315 (Revised), an important building block to Enhancing Audit Quality, which resulted in the publication of an Exposure Draft (ED) in July 2018 (ED-315).¹⁶ In developing its Work Plan for 2015-2016, the IAASB recognized that close coordination would be needed with the project to revise ISA 540 because the auditor’s risk assessment procedures in relation to accounting estimates are an extension of those required by ISA 315 (Revised). The IAASB also acknowledged that the revisions to ISA 540 needed to progress at a faster pace based on input from stakeholders, and therefore agreed that close coordination between the projects was necessary to keep the revisions to the respective standards in alignment.
8. In August 2018, the IAASB issued a supplemental, but related, ED, *ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement—Proposed Conforming Amendments to ISA 540 (Revised) and ISA 200 (Paragraph A42)*.¹⁷ This ED contains proposed changes that are indicative of those that would be necessary to conform the relevant requirements and application material paragraphs in ISA 540 (Revised) to the changes that have been proposed in ED-315. The two project Task Forces coordinated closely to minimize the extent of conforming changes to ISA 540 (Revised). As a result, the proposed conforming amendments to ISA 540 (Revised) that have been exposed for comment are generally limited to aligning concepts and terminology and do not change the performance requirements in ISA 540 (Revised).

Public Interest Issues

9. The table below shows the public interest outcomes identified by the IAASB in the project proposal and the subsequent decisions made to enhance the standard in the public interest, taking into account the comments received in response to ED-540 (paragraph references in this table are to ISA 540 (Revised)).

Public Interest Issues	IAASB Decisions
<p>Addressing evolving audit risks relating to accounting estimates, due to a more complex business environment</p> <ul style="list-style-type: none"> • Audit risks relating to accounting estimates are evolving and increasing because: <ul style="list-style-type: none"> ○ Financial reporting frameworks are evolving in a complex business environment, to require more complex accounting estimates with high estimation uncertainty (e.g., IFRS 9); and 	<p>The IAASB responded by:</p> <ul style="list-style-type: none"> • Introducing the concept of inherent risk factors, including not only estimation uncertainty but also complexity, subjectivity and others (paragraphs 2, 4, and 16). • Addressing the nature and extent of oversight and governance that the entity has in place over management’s process for making accounting estimates, in connection with obtaining an understanding of the entity’s internal control (paragraph 13).

¹⁵ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

¹⁶ <http://www.ifac.org/system/files/publications/files/Proposed-ISA-315-Revised-Explanatory-Memorandum.pdf>

¹⁷ http://www.ifac.org/system/files/publications/files/ED-ISA-315-Revised-Supplement-Conforming-Amendments-to-ISA-540-Revised-and-ISA-200_0.pdf

<ul style="list-style-type: none"> ○ Complex accounting estimates are becoming more prevalent generally and are now a fundamental part of the financial statements for some entities. ● Audit risks may arise because such accounting estimates require: <ul style="list-style-type: none"> ○ Significant management judgment, with potential for management bias and fraud in making such accounting estimates; ○ Use of more forward-looking information in making such accounting estimates and more related disclosures about such information; and ○ More disclosures about the measurement basis, estimation uncertainty, data and assumptions relating to such accounting estimates. ● Issues of concern to financial regulators have arisen, in a financial stability context, because making complex accounting estimates may require complex business processes (e.g., in the financial services industry), which may give rise to risks relating to the need for: <ul style="list-style-type: none"> ○ Reliance on technology to make such accounting estimates, particularly when they require large volumes of system-generated data; and ○ Reliance on greater oversight by management and governance in using complex models. ● Responding to the evolving audit risks may require a greater focus on the importance of testing the operating effectiveness of relevant controls for accounting estimates. 	<ul style="list-style-type: none"> ● Explicitly recognizing a spectrum of inherent risk (paragraph 4), and requiring a separate assessment of inherent risk and control risk (paragraph 16). Assessing inherent risk, and determining whether a risk is a significant risk (paragraph 17), involves considering the effect of the inherent risk factors and their inter-relationships. ● Referring to relevant requirements in ISA 315 (Revised) and ISA 330¹⁸ emphasizing the importance of the auditor's decisions about controls relating to accounting estimates (paragraphs 19 and 20). ● With respect to external information sources, making conforming and consequential amendments to the definitions, requirements and application material in ISA 500.¹⁹ The IAASB clarified that, in obtaining audit evidence regarding the risks of material misstatement relating to accounting estimates, and irrespective of the sources of information to be used as audit evidence, the auditor also is required to comply with the relevant requirements in ISA 500 (paragraph 30). ● Introducing objectives-based requirements directed to methods (including specifically when complex modelling is involved), data and assumptions, to design and perform further audit procedures and to respond to assessed risks of material misstatement. The further audit procedures need to be responsive to the assessed risks of material misstatement at the assertion level, taking into account the effect of one or more inherent risk factors and the auditor's assessment of control risk (paragraphs 7, 19, 22-25). ● With respect to disclosures: <ul style="list-style-type: none"> ○ Changing the objective of the standard to obtain sufficient appropriate audit evidence about whether "accounting estimates and related disclosures" in the financial statements are "reasonable" in the context of
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¹⁸ ISA 330, *The Auditor's Responses to Assessed Risks*

¹⁹ ISA 500, *Audit Evidence*

	<p>the applicable financial reporting framework (the objective in extant ISA 540 is that related disclosures are “adequate”) (paragraph 11).</p> <ul style="list-style-type: none"> ○ Enhancing the requirements to obtain audit evidence about whether the related disclosures are “reasonable” (paragraphs 26(b), 29(b) and 31). ○ Enhancing the overall evaluation requirements to determine whether the related disclosures are “reasonable” in the context of the applicable financial reporting framework, or are misstated (paragraph 35). <ul style="list-style-type: none"> ● Providing extensive new and revised application material supporting the requirements.
<p>Addressing audit quality for accounting estimates and fostering improved exercise of professional skepticism</p> <ul style="list-style-type: none"> ● Inspection findings raise significant concerns about audit quality for accounting estimates, and a need to address this by fostering a more independent and challenging skeptical mindset in auditors. 	<p>The IAASB responded by:</p> <ul style="list-style-type: none"> ● Enhancing the risk assessment procedures relating to obtaining an understanding of the entity and its environment, including the entity’s internal control (paragraph 13). ● Including a requirement to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory (paragraph 18). ● Including more granular, objectives-based, requirements for obtaining audit evidence (paragraphs 21–29). ● Enhancing the requirements to “stand back” and evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence (paragraphs 33–35). ● Using stronger language to reinforce the importance of exercising professional skepticism (see, for example, paragraphs A60, A95, and A135).
<p>Realizing public interest benefits through improved communication and transparency</p> <ul style="list-style-type: none"> ● Public interest benefits to governance, reporting and regulation may be realized through enhanced: 	<p>The IAASB responded by:</p> <ul style="list-style-type: none"> ● Enhancing the requirement to communicate with those charged with governance about significant qualitative aspects of the entity’s accounting practices (paragraph 38).

<ul style="list-style-type: none"> ○ Two-way dialogue between the auditor and those charged with governance, about complex accounting estimates with high estimation uncertainty, and about control deficiencies and changes to reporting standards for such accounting estimates; ○ Communication with supervisors and regulators, when required or in the public interest; and ○ Communication of Key Audit Matters relating to complex accounting estimates with high estimation uncertainty. 	<ul style="list-style-type: none"> ● Specifically noting that, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with other relevant parties, such as regulators and prudential supervisors (paragraph 38). ● Noting in the application material that if the auditor’s consideration of estimation uncertainty associated with an accounting estimate, and its related disclosures, is a matter that required significant auditor attention, then this may constitute a key audit matter (paragraph A114).
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10. The Appendix to this document shows how the IAASB addressed the list of public interest issues related to the project to revise ISA 540 that were provided to the IAASB by the Public Interest Oversight Board (PIOB). These issues were identified from observation activities by PIOB members and from analyses carried out by PIOB staff. Most of these issues were raised by PIOB observers during the course of meetings attended.

Scalability

Background

11. Throughout the development of ED-540, the IAASB had a continuing dialogue with the IFAC Small and Medium Practices (SMP) Committee and other relevant SMP stakeholders with the objective of minimizing unnecessary consequences for audits of smaller entities. To support a scalable application of the standard, ED-540 introduced a threshold to make requirements for more detailed objectives-based work effort requirements only applicable to accounting estimates when inherent risk was not assessed as “low.” Such conditional requirements were to design and perform further audit procedures to obtain sufficient appropriate audit evidence about certain matters relating to methods, assumptions and data when estimation uncertainty, complexity, judgment were the reasons for assessing inherent risk as other than “low.” The required work effort was therefore intended to be scalable to the nature of the identified and assessed inherent risk. In designing and performing further audit procedures when inherent risk was assessed as “low,” ED-540 required the auditor to determine whether one or more of three overall testing strategies would provide sufficient appropriate audit evidence in the circumstances.

Summary of Comments Received on Exposure

12. Overall, many respondents commented that ED-540 was sufficiently scalable, including expressing support for the use of a threshold of low inherent risk as a way to drive scalability. Respondents that supported the threshold approach noted that it is not necessary to perform the same level of work for an accounting estimate with “low” inherent risk as for an accounting estimate with higher inherent risk. By contrast, other respondents either opposed the threshold, or expressed various concerns about its practical application and believed that additional clarification or guidance was needed. Such concerns included whether the threshold was operable, whether it aligned with other ISAs (including

ISA 315 (Revised)), and how to apply it to material accounting estimates with low inherent risk. Many of those that supported the threshold also asked for more application material or examples to help assess inherent risk as “low” or “not low.”

13. Those that indicated that ED-540 was not sufficiently scalable often commented that the ED was too complex or confusing for “simple” accounting estimates, that substantial levels of documentation would be required, or that the risk assessment requirements (including the requirements related to obtaining an understanding of internal control) broadly were too onerous for simple accounting estimates.

IAASB Decisions

14. The IAASB acknowledged that scalability was important, but concluded that it could be provided without the need for a threshold, which would also address the concerns about how such a threshold would be applied in practice.
15. To demonstrate that ISA 540 (Revised) is scalable for all types of accounting estimates, from those that are relatively “simple” to those that are complex, the IAASB decided to:
 - Introduce and emphasize a spectrum of inherent risk concept, building on existing concepts in ISA 200,²⁰ ISA 315 (Revised), and ISA 330. Under the spectrum of inherent risk concept, the assessment of inherent risk depends on the degree to which the inherent risk factors affect the likelihood or magnitude of misstatement, and varies on a scale. The spectrum of inherent risk concept is explained in paragraph 4 of ISA 540 (Revised);
 - Highlight that the nature, timing and extent of the risk assessment and further audit procedures required by ISA 540 (Revised) will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement associated with the accounting estimate (paragraph 3);
 - Include specific paragraphs in the application material that demonstrate how ISA 540 (Revised) is scalable depending on the risk assessment (paragraphs A20-A23) and the responses to the assessed risks of material misstatement (paragraph A84);
 - Retain the requirement in ED-540 that the auditor’s further audit procedures need to be responsive to the reasons for the assessment of the risks of material misstatement at the assertion level (paragraph 18) and highlighted this as well in the Key Concepts section;
 - Retain the wording from paragraph 7(b) of ISA 330 that the auditor’s further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be (paragraph 18). The IAASB also added corresponding wording for tests of controls in paragraph 19.

²⁰ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

Professional Skepticism

Background

16. The IAASB recognizes the central role that professional skepticism plays in auditing accounting estimates. Therefore, ED-540 contained several key provisions that were designed to enhance the auditor's application of professional skepticism, including:
- Enhanced risk assessment requirements that provide a better basis for identifying and assessing the risks of material misstatement related to accounting estimates;
 - More granular, objectives-based requirements to obtain audit evidence about particular matters when inherent risk is not low; and
 - A requirement to “stand back” and consider all audit evidence obtained, whether corroborative or contradictory, when evaluating whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Summary of Comments Received on Exposure

17. Respondents generally believed that the approach taken in ED-540 appropriately reinforced the application of professional skepticism when auditing accounting estimates. Several aspects of ED-540 were mentioned as key improvements in this regard, including the stand-back provision.
18. Specific comments were received noting that the effective exercise of professional skepticism is important with respect to the auditor's evaluation of management's judgments relating to accounting estimates, particularly when those judgments are subjective and there is greater opportunity for management bias. This involves evaluating whether management's judgments are appropriate, including whether there is evidence to suggest that other alternatives (e.g., methods, assumptions or data) may be more appropriate in the circumstances, and questioning or challenging management when it is appropriate to do so. Accordingly, suggestions were received for the IAASB to consider the use of words such as “question” or “challenge” in the requirements to drive appropriate auditor behavior in the audit of accounting estimates, including the exercise of professional skepticism.

IAASB Decisions

19. Based on the support from respondents for the stand-back requirement with respect to audit evidence (“consider all evidence obtained, whether corroborative or contradictory”), the IAASB determined that similar wording also should be included earlier in the requirements section to enhance professional skepticism in obtaining audit evidence. The IAASB therefore added a requirement in paragraph 19 to drive auditors to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory.
20. The IAASB also added application material to indicate that obtaining audit evidence in an unbiased manner may involve obtaining evidence from multiple sources within and outside the entity. However, the IAASB does not intend for the auditor to perform an exhaustive search to identify all possible sources of audit evidence (paragraph A82).
21. The IAASB acknowledged that using terms such as “challenge” or “question” would be responsive to the calls, particularly from regulators and investors, for stronger language to reinforce the importance of exercising professional skepticism in auditing accounting estimates. The IAASB agreed to include

terms such as “challenge”, “question” and “reconsider” in several places of ISA 540 (Revised), including:

- Retrospective review (paragraph A60);
 - Changes in methods, significant assumptions and the data from prior periods (paragraph A95);
 - Indicators of management bias (paragraph A96); and
 - Overall evaluation based on audit procedures performed (paragraphs A137 and A139).
22. The IAASB noted that the structure and flow of the stand-back provisions could be improved (paragraphs 33–36). Accordingly, the requirement for the auditor to take into account all relevant audit evidence obtained, whether corroborative or contradictory, has been separated into a new paragraph (paragraph 34). This paragraph also notes that if the auditor is unable to obtain sufficient appropriate audit evidence, then the auditor needs to evaluate the implications for the audit in accordance with ISA 705 (Revised).²¹ In addition, the IAASB included, in paragraph 35, essential application material to highlight how misstatements may be distinguished.
23. The IAASB also considered, and decided against, adding a specific requirement to document how the auditor exercised professional skepticism with respect to accounting estimates. The IAASB noted that ISA 230²² already contains application material indicating that there may be no single way in which the auditor’s professional skepticism is documented. However, the IAASB decided to make a consequential amendment to paragraph A7 of ISA 230 to provide an example of how the exercise of professional skepticism could be documented in relation to accounting estimates and illustrate how professional skepticism could be demonstrated when the auditor obtains evidence that both corroborates and contradicts management’s assertions. In addition, the IAASB agreed to add application material in ISA 540 (Revised) (paragraph A152) noting examples of requirements in ISA 540 (Revised), the documentation of which may provide evidence of the exercise of professional skepticism by the auditor.

Risk assessment

Background

24. The IAASB’s outreach indicated that there were possible areas for improvement in extant ISA 540, including improving the consistency in the extent to which auditors obtain an understanding of the data, assumptions, and methods that are used to make accounting estimates, focusing on the internal consistency of management assumptions used, and how management has understood and addressed estimation uncertainty. The IAASB also noted that changes in the business environment, including the increasing complexity of information systems and the use of complex modelling, the use of information from external sources, and the importance of the regulatory environment in certain industries are not adequately emphasized in extant ISA 540. As a result, the IAASB determined that a key focus for the project was enhancing the risk assessment requirements for accounting estimates to support professional skepticism and to better identify risks of material misstatement at an appropriately granular level based on the enhanced understanding.

²¹ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*

²² ISA 230, *Audit Documentation*

25. Paragraph 10 of ED-540 addressed these points through requiring the auditor to obtain an understanding of:
- The regulatory factors, if any, relevant to accounting estimates;
 - The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements;
 - The use of models; the process used to select data, including the source(s) of that data and how management identifies data; and
 - Each of the components of internal control as they relate to accounting estimates.

Summary of Comments Received on Exposure

26. While many respondents supported the IAASB's proposed risk assessment procedures (paragraph 10 of ED-540), there were concerns about scalability, particularly the requirements related to obtaining an understanding of internal control, which were considered by some respondents to be too onerous for simple accounting estimates. Respondents also noted that the relationship between paragraph 10 of ED-540 and ISA 315 (Revised) was unclear, that the inherent risk factors should be included in the risk assessment, and that the requirements should reinforce how management uses methods, data, and assumptions in making the accounting estimates. There were also concerns about the overall clarity and length of that paragraph.

IAASB Decisions

27. The IAASB agreed with respondents that believed that more needed to be done to clarify how the risk assessment requirements would be scalable. Accordingly, paragraph 13 of ISA 540 (Revised) now clarifies that the procedures to obtain an understanding of the entity and its environment, including the entity's internal control, need to be performed to the extent necessary to provide an appropriate basis for the identification and assessment of the risks of material misstatement at the financial statement and assertion levels. See paragraphs 14-15 above for more information on the IAASB's decisions regarding the scalability of ISA 540 (Revised).
28. The IAASB acknowledged that the linkage to ISA 315 (Revised) could be clarified and included paragraph A19 in ISA 540 (Revised) to explain the relationship. Subheadings have been used in paragraph 13 of ISA 540 (Revised) to align with the subheadings in ISA 315 (Revised) and some of the subparagraphs were reordered and edited to better align with ISA 315 (Revised). Due to the improved alignment with ISA 315 (Revised), the IAASB decided to remove the broad reference to "each of the components of internal control as they related to making accounting estimates," to address comments from respondents to ED-540 that this would be too onerous for simple accounting estimates. Instead, the IAASB decided to build upon other requirements in paragraph 10 of ED-540 that already addressed obtaining an understanding of the components of the system of internal control (see, for example, the requirements on control activities relevant to the audit over management's process for making accounting estimates (paragraph 13(i)) and how management reviews the outcomes of previous accounting estimates (paragraph 13(j)).
29. The IAASB also acknowledged that ED-540 could have been read to imply that the provisions of paragraph 10(e) of ED-540 applied to all accounting estimates, regardless of the significance of the accounting estimate. The IAASB concluded that paragraph 13(h) of ISA 540 (Revised) should have

the same scope as the equivalent requirements in ISA 315 (Revised),²³ as this would clarify that the required risk assessment procedures would apply only to classes of transactions, events and conditions that are significant to the financial statements and that give rise to the need for, or changes in, accounting estimates and related disclosures, rather than to all accounting estimates.

30. The application material to this section was amended to align with the new structure of paragraph 13. The IAASB also streamlined this application material to reduce complexity, with certain material being repurposed as guidance for the introduction or the work effort paragraphs of ISA 540 (Revised).

Inherent Risk Factors

Background

31. Extant ISA 540 focuses specifically on estimation uncertainty with respect to the identification and assessment of the risks of material misstatement. Outreach performed by the IAASB indicated that there may be other factors that influence the risks of material misstatement in relation to an accounting estimate. Therefore, in identifying and assessing risks of material misstatement in relation to an accounting estimate, ED-540 required the auditor to take into account the extent to which the accounting estimates is subject to, or affected by, one or more relevant factors, including:

- Complexity;
- The need for the use of judgment by management; and
- Estimation uncertainty.

Summary of Comments Received on Exposure

32. Generally, respondents to ED-540 supported the inherent risk factors, specifically the consideration of these factors in identifying and assessing the risks of material misstatement. However, some respondents were of the view that more emphasis should be placed on possible other inherent risk factors, to align with proposals being developed to revise ISA 315, and also questioned if alignment in the wording used to describe inherent risk factors could be achieved both with the proposals to revise ISA 315 and with similar terms used by the United States Public Company Accounting Oversight Board (PCAOB) in its proposed auditing standard on accounting estimates.

IAASB Decisions

33. In response to comments received, the IAASB agreed to make the following changes to the inherent risk factors in the identification and assessment of the risks of material misstatement relating to accounting estimates and related disclosures:
- Including a reference to other relevant inherent risk factors in the requirement to identify and assess the risks of material misstatement to place more emphasis on other inherent risk factors, namely 'change' and the 'susceptibility to misstatement due to management bias or fraud'. The IAASB specifically highlighted the inherent risk factor 'susceptibility of the accounting estimate to misstatement due to management bias or fraud' by explaining that:

²³ ISA 315 (Revised), paragraphs 18(a) and (d)

- The degree of subjectivity associated with an accounting estimate influences the susceptibility of the accounting estimate to misstatement due to management bias or fraud (paragraph A79); and
 - The exercise of professional skepticism is important when there is greater susceptibility to misstatement due to management bias or fraud (paragraph 8)
 - Changing the name of the inherent risk factor 'judgment' to 'subjectivity,' without changing its nature. By doing so the IAASB aligned the wording with ED-315 and the PCAOB's proposed standard on auditing accounting estimates.
 - Referring to the inherent risk factor 'estimation uncertainty' separately from the other inherent risk factors by including it in a separate bullet in paragraph 16. The IAASB decided that estimation uncertainty influences the other inherent risk factors and that referring to it separately would help to explain its relationship with the other inherent risk factors.
 - Adding 'the degree to which ...' before the inherent risk factors to reflect scalability by emphasizing the need to consider the extent to which the accounting estimate is subject to estimation uncertainty or the extent to which the other inherent risk factors affect susceptibility to misstatement through linking the effect of the risk factors to the selection of the data, assumptions, and methods used and the selection of management's point estimate and disclosures. The relationship between the inherent risk factors and data, assumptions, and methods is further explained in the application material.
34. To improve clarity of the standard, the IAASB has included the determination of whether any of the identified risks give rise to a significant risk as a separate requirement (paragraph 17). This determination is also included as a separate requirement in extant ISA 540.
35. In response to comments received on the interrelationships between inherent risk factors, the IAASB agreed to better explain the application of the inherent risk factors throughout the standard, but specifically in the application material to paragraph 16 (paragraphs A64–A79) to highlight how these factors relate to methods, assumptions and data.
36. In addition, the IAASB clarified the interrelationships among the inherent risk factors by:
- Including references throughout the ISA to Appendix 1, which further explains the nature of the inherent risk factors of estimation uncertainty, subjectivity and complexity, and their interrelationships, in the context of making accounting estimates and selecting management's point estimate and related disclosures for inclusion in the financial statements (paragraphs A8, A66);
 - Referring to estimation uncertainty separately from the other inherent risk factors (as described in paragraph 33 above); and
 - Explaining the inherent risk factors in the Nature of Accounting Estimates section in the introduction to the revised standard.

Separate Assessments of Inherent and Control Risk

Background

37. ED-540 focused in several places on the inherent risk factors, including the consideration of those factors in identifying, assessing and responding to the risks of material misstatement. Paragraph 15 of ED-540 required the auditor, in applying ISA 330, to design and perform further audit procedures

to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. Paragraph A94 of ED-540 referenced the requirement in paragraph 7 of ISA 330, which requires the auditor, in designing the further audit procedures to be performed, to consider the reasons for the assessment given to the risk of material misstatement at the assertion level, including inherent risk and control risk.

IAASB Decisions

38. Given that the proposed revisions to ISA 315 (Revised) included a separate assessment of inherent and control risk, the IAASB continued to discuss the separate assessment of inherent and control risk for accounting estimates in seeking to move away from using a threshold of low inherent risk and towards emphasizing the spectrum of inherent risk.
39. The IAASB discussed whether the reference to the separate and combined assessments of inherent and control risk could be removed from ISA 200, but concluded that respondents to ED-540 did not have the opportunity to comment on making that change, and therefore this should be addressed in the project to revise ISA 315 (Revised).
40. In discussions about the proposed conforming amendment to paragraph A42 of ISA 200, the IAASB expressed concerns that the proposed wording may be confusing, given the statement in that paragraph that the ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. Although some Board members suggested that any change to ISA 200 should await deliberation as part of the ISA 315 project, the Board was supportive of addressing separate assessments of inherent risk and control risk more narrowly, in the context of accounting estimates, within the scope of the ISA 540 project.
41. Accordingly, the IAASB agreed to:
 - Add an explicit requirement (paragraph 16) for the auditor to separately assess inherent and control risk in identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level; and
 - Make a conforming amendment to paragraph A42 of ISA 200 to highlight this explicit requirement and to explain that, for ISA 540 (Revised), a separate assessment of inherent risk and control risk is performed to provide a basis for designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, for accounting estimates.

Work Effort

Background

42. Extant ISA 540 requires the auditor to undertake one or more of four responses to the risks of material misstatement relating to an accounting estimate:
 - Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate;
 - Test how management made the accounting estimate and the data on which it is based;
 - Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures; and

- Develop a point estimate or a range to evaluate management's point estimate.
43. During outreach and the related IAASB discussions in developing ED-540, it was suggested that, in some cases, auditors may not identify and assess risks of material misstatement relating to accounting estimates at a sufficiently granular level, which may result in developing and performing further audit procedures that do not provide sufficient appropriate audit evidence to address the risks.
44. In response to these concerns, the IAASB chose to develop an approach in ED-540 that:
- Required the auditor to take into account, in designing and performing further audit procedures, the extent to which accounting estimates are subject to or affected by the inherent risk factors in order to drive further audit procedures that are more responsive to the nature and circumstances of the risks of material misstatement.
 - Supported scalable application of the standard by introducing more detailed objectives-based requirements to design and perform further audit procedures to obtain sufficient appropriate audit evidence about certain matters when inherent risk is not low.
 - When inherent risk is low, required the auditor to determine whether one or more of the following three testing strategies would provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement:
 - Obtaining audit evidence about events occurring up to the date of the auditor's report;
 - Testing how management made the accounting estimate and the data on which it is based; and
 - Developing a point estimate or range based on available audit evidence to evaluate management's point estimate.
 - Noted that the auditor's further audit procedures (whether substantive procedures or tests of controls) have to be responsive to the reasons for the assessment given to the risk of material misstatement and that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. This is intended to remind the auditor of the obligation under paragraph 7(a) of ISA 330 and reinforce the need for the auditor's responses to be commensurate with the assessed risks of material misstatement; and
 - Reminded the auditor of the need to test the operating effectiveness of controls when the auditor intends to rely on those controls relating to accounting estimates or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Summary of Comments Received on Exposure

45. There were mixed views as to whether the response to the assessed risks of material misstatement should be based around each inherent risk factor. Some respondents noted that the interrelationship between the inherent risk factors made it challenging to determine the appropriate response to the assessed risks of material misstatement because the assessed risks could relate to one or more inherent risk factors. These respondents believed that categorizing responses by the inherent risk factors would generally not be consistent with management's process for making accounting estimates and the auditor's approach to obtaining audit evidence, as management and the auditor often consider accounting estimates more in terms of evaluating the methods, assumptions and data used.

46. Respondents to ED-540 variously noted that the work effort requirements may be difficult to apply in practice, may lead to inconsistencies in application and interpretation, and may result in less professional judgment and professional skepticism being exercised.
47. Other comments on the structure of the work effort section included that it was unclear:
 - Whether the testing strategies for low inherent risk accounting estimates are also applicable to accounting estimates for which inherent risk is not low.
 - Whether, and the extent to which, the objectives-based requirements that apply when inherent risk is not low may also be applicable for accounting estimates with low inherent risk.
 - Why certain requirements were only listed under a single inherent risk factor (e.g., certain objectives-based requirements for complexity may also be applicable for judgment).

IAASB Decisions

Testing Strategies

48. Given the responses received, the IAASB agreed to reduce the complexity caused by the direct link between the inherent risk factors and the requirements addressing the response to the assessed risk of material misstatement. See paragraphs 53-55 below for the IAASB's decisions in this regard.
49. The IAASB concluded that the clarity of the standard would be enhanced by including the testing strategies in a separate requirement that applies to all accounting estimates. This approach is similar to extant ISA 540, and also would be consistent with the approach proposed by the PCAOB. The IAASB also explained in the application material that one or a combination of the testing strategies can be selected in responding to the assessed risk of material misstatement (paragraph A81).

Controls Testing

50. Given the support for highlighting the ISA 330 requirement to test the operating effectiveness of controls when the auditor intends to rely on those controls or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the IAASB decided to retain the requirement (paragraph 19) and enhance it by adding that:
 - The design and performance of tests of relevant controls shall be responsive to the reasons for the risks of material misstatement; and
 - The auditor shall take into account that the greater the reliance placed on the effectiveness of a control, the more persuasive the audit evidence needs to be.

These additions are based on paragraph 7 and paragraph 9 of ISA 330, respectively.

51. Given the importance of controls over accounting estimates in some industries, the IAASB highlighted in the application material to paragraph 19 that in some industries, such as the financial services industry, management makes extensive use of IT to conduct business and it may therefore be more likely that there are risks related to certain accounting estimates for which substantive procedures alone cannot provide sufficient appropriate audit evidence.
52. Given the importance of control testing to many stakeholders, the IAASB also highlighted (in paragraph 20) the existing requirements in paragraph 15 and 21 of ISA 330. Paragraph 20 of ISA 540 (Revised) highlights that for significant risks relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the current period if the auditor plans to rely

on those controls, and that when the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

Work Effort Paragraphs

53. Given that ISA 540 (Revised) will be used for all accounting estimates, from simple to complex, and that respondents did not have many comments on the objectives-based requirements themselves, the IAASB decided that the objectives-based requirements should be retained, but restructured.
54. The IAASB decided to restructure the objectives-based requirements in the work effort around the three testing strategies (paragraphs 21-30). The IAASB believes that retaining the objectives-based requirements under this alternative structure is responsive to stakeholders that supported the objectives-based approach in ED-540, as well as to those who wanted improvements to the clarity, understandability, and operability of the standard. The IAASB also noted that this approach is similar to extant ISA 540 and the PCAOB's proposed standard.
55. The IAASB decided to structure the requirements around methods, assumptions and data instead of the risk factors (complexity, subjectivity and estimation uncertainty). The IAASB believes that this structure makes designing the response to risks of material misstatement more intuitive for the auditor, as it would be more consistent with how management makes the accounting estimate and how the auditor would obtain audit evidence to address the risks.

Significant Risks

56. The IAASB discussed again whether specific procedures could be required for significant risks, which would be different from procedures performed for other risks of material misstatement, but did not identify any. Given the limited number of respondents who raised this point, and in light of the proposal to drive scalability by highlighting the spectrum of inherent risk (including significant risks) in the standard, the IAASB did not add specific requirements for significant risks in ISA 540 (Revised).

Developing an Auditor's Range

Background

57. Under extant ISA 540, if the auditor concludes that it is appropriate to develop a range to evaluate management's point estimate, the auditor is required to narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable.
58. The guidance in extant ISA 540 on narrowing the range indicates, among other matters, that the auditor's range is required to encompass all "reasonable outcomes" rather than all possible outcomes. It also indicates that a range that has been narrowed to be equal to or less than performance materiality ordinarily is adequate for evaluating management's point estimate (although also noting that in some industries it may not be possible to do so). The IAASB discussed concerns that this approach to "narrowing the range," coupled with a lack of explanation about what would constitute a "reasonable outcome," could result in an auditor's range that was inappropriately wide. Therefore, the IAASB agreed not to retain this approach.
59. When the reasons for the assessment given to a risk of material misstatement included estimation uncertainty, and inherent risk was not low, paragraph 19(a) of ED-540 required the auditor to obtain sufficient appropriate audit evidence about whether management has taken appropriate steps to understand and address estimation uncertainty and to develop a point estimate and related

disclosures that are reasonable. If, in the auditor's judgment, management has not done so, paragraph 19(b) required the auditor, to the extent possible, to develop an auditor's point estimate or range to enable the auditor to evaluate the reasonableness of management's point estimate and the related disclosures that describe the estimation uncertainty.

60. If the auditor concluded that it was appropriate to develop an auditor's range, paragraph 20 of ED-540 required the auditor to include in that range only amounts that:
- Are supported by the audit evidence; and
 - The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.

Summary of comments received on exposure

61. A majority of respondents indicated generally that the requirement in paragraph 20 of ED-540, along with the related application material, appropriately established how the auditor's range should be developed, often noting that this will be more effective or a better approach than the concept of "narrowing the range" in extant ISA 540. Respondents also commented on the need for additional guidance in this area.
62. Some respondents suggested that the IAASB clarify that paragraph 20 applies in all instances when the auditor concludes that it is appropriate to develop an auditor's range. The placement of this requirement in ED-540 suggested to some that it only applied when, in the auditor's judgment, management had not appropriately understood and addressed estimation uncertainty. Several respondents further commented that the requirement in paragraph 19(b) and related application material in ED-540 could lead to concerns about the auditor assuming the responsibilities of management, or otherwise raise concerns about the auditor's independence.
63. While expressing support for the guidance that, in certain circumstances, the auditor's range may be multiples of materiality for the financial statements as a whole, respondents had various suggestions for revising or further clarifying this guidance. These suggestions included explaining why the auditor's evaluation of the reasonableness of disclosures becomes increasingly important in these circumstances, and noting that the nature of the estimation uncertainty and the requirements of the applicable financial reporting framework will be relevant in considering the disclosures that may be needed.

IAASB decisions

64. The IAASB clarified that developing an auditor's point estimate or range is one of the strategies that may be selected to respond to the assessed risks of material misstatement at the assertion level. In addition, similar to extant ISA 540, the auditor is required, to the extent practicable, to develop an auditor's point estimate or range if the auditor determines that management has not sufficiently addressed estimation uncertainty.
65. When the auditor develops a point estimate or range to evaluate management's point estimate and related disclosures about estimation uncertainty, the IAASB required the auditor's further audit procedures to include procedures to evaluate whether the methods, assumptions or data used are appropriate in the context of the applicable financial reporting framework. Regardless of whether the auditor uses management's or the auditor's own methods, assumptions or data, these further audit procedures are required to be designed and performed to address the matters in paragraphs 23–25.

Application material (paragraph A123) was added to emphasize that, when using the auditor's own methods, assumptions or data to develop a point estimate or range, the auditor may obtain evidence about the appropriateness of management's methods, assumptions or data.

66. The IAASB further discussed and retained the requirement in ED-540 that, if the auditor develops an auditor's range to evaluate management's point estimate and related disclosures about estimation uncertainty, the auditor needs to determine that the range includes only amounts that are supported by sufficient appropriate audit evidence and have been evaluated by the auditor to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.
67. The IAASB also explained in application material that the requirement to determine that the range includes "only amounts that are supported by sufficient appropriate audit evidence" does not mean that the auditor is expected to obtain audit evidence to support each possible outcome in the range individually. Rather, the auditor is likely to obtain evidence to determine that the points at both ends of the range are reasonable in the circumstances, thereby supporting that amounts falling between those two points also are reasonable.
68. With respect to the size of the auditor's range being multiples of materiality for the financial statements as a whole, the IAASB expanded the application material (paragraph A125) to clarify that:
 - (i) This situation is more likely to arise in circumstances when the estimation uncertainty associated with the accounting estimate is itself multiples of materiality, which is more common for certain types of accounting estimates or in certain industries, such as insurance or banking, where a high degree of estimation uncertainty is more typical and there may be specific requirements in the applicable financial reporting framework in that regard.
 - (ii) When the auditor concludes, based on the procedures performed and audit evidence obtained, that a range that is multiples of materiality is, in the auditor's judgment, appropriate in the circumstances, the auditor's evaluation of the reasonableness of the disclosures about estimation uncertainty becomes increasingly important, particularly whether such disclosures appropriately convey the high degree of estimation uncertainty and the range of possible outcomes.
 - (iii) The considerations in paragraphs A139-A144 also may be relevant in these circumstances. In particular, when the audit evidence supports a range that is multiples of materiality, the exercise of professional skepticism is important in determining whether management's point estimate and related disclosures are reasonable, or are misstated. Although a wide range may be appropriate in the circumstances, it may indicate that it is important for the auditor to reconsider whether sufficient appropriate audit evidence has been obtained regarding the reasonableness of the amounts within the range.
69. To address concerns raised by respondents about the auditor assuming the responsibilities of management, or otherwise creating threats to the auditor's independence, the IAASB restructured paragraph 19(b) of ED-540. A requirement was added for the auditor to first request management to perform additional procedures when, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty. The IAASB also added application material (paragraph A116) indicating that, in considering whether it is practicable to develop an auditor's point estimate or range, the auditor may need to take into account whether the auditor could do so without compromising independence requirements, and also

consider relevant ethical requirements that address prohibitions on assuming management responsibilities.

Disclosures

Use of the Term “Reasonable”

Background

70. The word “reasonable” is used in extant ISA 540 in the objective and many key requirements. In extant ISA 540, the objective of the standard uses the term “reasonable” for accounting estimates but “adequate” for disclosures, although neither term is defined or explained further. In developing ED-540, the IAASB concluded that both the accounting estimate and the related disclosures should be “reasonable in the context of the applicable financial reporting framework,” as continuing to use “adequate” may inappropriately suggest that disclosures are less important than the accounting estimate itself.
71. In aligning the objective of ED-540 to refer to “reasonable in the context of the applicable financial reporting framework” for the accounting estimate and related disclosures, the IAASB recognized that ISA 700 (Revised)²⁴ uses the terms “reasonable,” “appropriate” and “adequate” in relation to disclosures.²⁵ Noting a degree of inconsistency, the IAASB decided not to make conforming amendments to ISA 700 (Revised) in connection with ED-540, but rather to consider the need to do so as part of the planned post-implementation review of the auditor reporting standards. ED-540 also provided an explanation of reasonable and how this relates to “appropriate.”

Summary of Comments Received on Exposure

72. Respondents to ED-540 commented in various ways about the use of the term “reasonable,” including:
- The inconsistencies with some of the terms in ISA 700 (Revised), including suggestions for conforming amendments to ISA 700 (Revised);
 - Whether “reasonable” should be included in the definitions;
 - Whether using “reasonable” as the evaluation criterion for disclosures related to accounting estimates creates a stronger criterion for these disclosures compared with other disclosures (including qualitative disclosures) in the financial statements; and
 - Consistency of the use of the terms “reasonable,” “appropriate,” and “adequate” throughout the standard.

IAASB Decisions

73. The IAASB discussed the use of “reasonable” in the objective of the standard, and concluded that this is the appropriate criterion for both the accounting estimate and related disclosures. However, in view of the comments received on the inconsistencies with the terminology in ISA 700 (Revised), the IAASB agreed to make a conforming amendment to paragraph 13(c) of ISA 700 (Revised) that requires the auditor to evaluate whether related disclosures made by management, as well as the

²⁴ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

²⁵ ISA 700 (Revised), paragraphs 13(b), 13(e), and 39(b)(iii)

accounting estimates, are reasonable in view of the requirements of the applicable financial reporting framework.

74. The IAASB also discussed whether a conforming amendment should be made to paragraph 13(e) of ISA 700 (Revised), which requires the auditor to "... evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide *adequate* disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements." The IAASB believed that the use of "adequate" in this context is related to the sufficiency and completeness of the disclosures needed to enable the intended users to understand the effect of material transactions and events on the entity's financial position, financial performance and cash flows. Accordingly, the IAASB is not making a conforming amendment to paragraph 13(e).
75. The IAASB considered whether the term "reasonable" should be included in the definitions of ISA 540 (Revised) and continues to believe, consistent with ED-540, that doing so could lead to questions or confusion with the many uses of the term in different contexts throughout the ISAs. However, the IAASB concluded that it would be responsive to comments received to give more prominence to what is meant by the phrase 'reasonable in the context of the applicable financial reporting framework' and therefore included paragraph 9 in the Key Concepts section and added application material (paragraphs A12-A13) that further explains the IAASB's rationale.

Disclosure Requirements

Background and Summary of Comments Received on Exposure

76. The IAASB has noted the increasingly important role of disclosures in financial reporting, particularly with respect to accounting estimates, and has already completed a project addressing the audit implications of disclosures in general. The IAASB noted that, in many cases, disclosures relating to accounting estimates are critical to users' understanding of the accounting policies applied, the nature and extent of estimation uncertainty, and key judgments and other matters relating to accounting estimates, in particular when estimation uncertainty is high. ED-540 continued the IAASB's emphasis on the importance of disclosures by including requirements addressing:
- Disclosures that describe estimation uncertainty; and
 - Other disclosures related to accounting estimates.

In addition, the new stand back requirement included an evaluation of whether management's decision relating to the recognition, measurement, presentation and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework.

77. Respondents generally supported the increased focus on disclosures as they are so important to users' understanding of estimation uncertainty. A few respondents were of the view that ED-540 did not adequately emphasize the importance of appropriate disclosures.

IAASB Decisions

78. Given the general support for the disclosure requirements, the IAASB decided to make limited changes to the requirements in ED-540. The IAASB was of the view that application material explaining the relationships and distinctions between the various paragraphs that address disclosures would be useful as the IAASB's intentions may not have been clear. The IAASB therefore

agreed to add paragraph A141 to explain the relationship between the requirements that relate to obtaining sufficient appropriate audit evidence about disclosures (including those that describe estimation uncertainty) and the requirement in paragraph 35 to evaluate whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Other matters

Linkages to Other Standards

Background and Summary of Comments Received on Exposure

79. The IAASB recognizes the importance of having clear linkages from ISA 540 (Revised) to other standards because ISA 540 (Revised) expands on how ISA 315 (Revised), ISA 330, ISA 450,²⁶ ISA 500 and other relevant ISAs are to be applied in relation to accounting estimates.
80. The IAASB particularly discussed the linkage between ISA 540 (Revised) and ISA 500 given the conforming and consequential amendments to bring in guidance on external information sources. When an external information source is used, it often relates to making an accounting estimate. Therefore, before finalizing ED-540, the IAASB discussed whether the guidance relating to the use of external information sources should be included in ISA 540 (Revised) or ISA 500. The IAASB decided to incorporate the proposed new application material on external information sources within ISA 500.
81. Some respondents were of the view that the suggested changes to ISA 500 would be better located within ISA 540. Other respondents called for a more explicit linkage from ED-540 to the new application material in ISA 500 in respect of both information from an external information source and work of a management's expert.

IAASB Decisions

82. To address the comments received the IAASB decided to:
 - Highlight in the requirements (paragraph 30) that the auditor shall comply with the relevant requirements in ISA 500. The application material to this paragraph addresses the use of a management's expert, an external information source or a service organization when auditing an accounting estimate. Paragraph 30 also states that, when using the work of a management's expert, the requirements in paragraphs 21–29 may assist the auditor in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion. It was not the IAASB's intention that the auditor should address every single requirement in paragraphs 21-29 when using the work of a management's expert but that the auditor may consider the matters described in paragraphs 21-29.
 - Move several paragraphs (paragraphs A126 to A129) from ISA 500 to ISA 540 (Revised) as the IAASB was of the view that these paragraphs were specific to accounting estimates and were therefore better placed in ISA 540 (Revised).
 - Enhance the references in the requirements and application material, including footnote references, to other ISAs.

²⁶ ISA 450, *Evaluation of Misstatements Identified during the Audit*

83. The IAASB also highlighted in the application material that assumptions relating to accounting estimates that are made or identified by a management's expert become management's assumptions when used by management in making an accounting estimate (paragraph A130).

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

Background and Summary of Comments Received on Exposure

84. In developing ED-540, the IAASB recognized the importance of a two-way dialogue between the auditor and those charged with governance. Therefore, the IAASB included a new requirement in ED-540 that placed more emphasis on communications with those charged with governance or management regarding accounting estimates. The application material included guidance on communications with regulators as the IAASB was of the view that this application material is particularly important for audits of financial institutions. Respondents to the ED supported the new requirement and application material.

IAASB Decisions

85. Given the broad support, the IAASB made only limited changes to the requirement. The IAASB agreed to highlight that, in certain circumstances, the auditor may be required by law or regulation to communicate about certain matters with regulators and prudential supervisors, as it concluded that doing so would be in the public interest.

Documentation

Background and Summary of Comments Received on Exposure

86. In developing ED-540, the IAASB recognized that the documentation requirements in ISA 230 would already apply to many of the auditor's judgments required by ED-540. Accordingly, the IAASB included application material in ED-540 that reinforced the link back to the documentation requirement in ISA 230, and highlighted aspects of the auditor's work under ED-540 that likely would give rise to judgments that would be documented under ISA 230. In addition, the extant ISA 540 documentation requirement was extended to include documentation of not only indicators of possible management bias, if any, identified but also of the auditor's evaluation thereof in forming the opinion on the financial statements as a whole.
87. Some respondents to ED-540 were of the view that the documentation requirement could be clarified, particularly the expectations for documentation of the risk assessment procedures, the reasons for the assessed risk of material misstatement, the response to the assessed risk of material misstatement, the stand back, and the auditor's consideration of management bias.

IAASB Decisions

88. To address the comments received on exposure, the IAASB decided to expand the documentation requirement by including several areas in ISA 540 that should be documented:
- For the risk assessment procedures, key elements of the auditor's understanding of the entity and its environment. This requirement is based on paragraph 32(b) of ISA 315 (Revised);
 - In the responding to the assessed risks of material misstatement:

- The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, taking into account the reasons given to the assessment of those risks. This requirement is based on paragraph 28(b) of ISA 330 (Revised); and
 - The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty; and
 - Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.
89. In addition to expanding the documentation requirement, the IAASB was of the view that the application material could be enhanced by explaining other matters that the auditor may consider documenting when management's application of the method involves complex modeling and when the selection and application of methods, significant assumptions, or the data is affected by complexity to a higher degree.
90. The IAASB also included examples of requirements in ISA 540 (Revised) for which documentation in support of the requirement may provide evidence of the exercise of professional skepticism by the auditor to support the consequential amendment to paragraph A7 of ISA 230.

Restructuring of the Application Material and Appendices

Background and Summary of Comments Received on Exposure

91. Many comments were received from respondents on the application material in ED-540, both positive and negative, including a significant number of suggestions for restructuring this material. One key theme of the comments was that the application material was complex and needed restructuring to assist readers in obtaining a proper understanding of the concepts, and in applying the requirements, and in navigating through the application material. In addition, there were many calls for additional guidance on a variety of topics.
92. A significant number of comments were received asking for additional guidance or examples, particularly with respect to audits for smaller entities, professional skepticism, internal controls, the inherent risk assessment, the auditor's development of a point estimate or range, and clarification of the meanings of certain terms in the application or requirements.
93. Respondents that commented on Appendices 1 and 2 of ED-540 had mixed views. Some respondents suggested that one or both of the appendices were educational and did not need to be included in the ISA, while other respondents supported including them.

IAASB Decisions

94. To address the comments received, the IAASB analyzed, reviewed and discussed the application material, with a view to clarifying and restructuring it to:
- Delete or re-purpose material that was considered repetitive of guidance in other ISAs;
 - Reorganize paragraphs (or specific sentences within paragraphs) to better align with the restructured requirements; and

- Change certain parts of the application material that were considered to be educational in style to include relevant considerations for the auditor to support the consistent and effective implementation of the requirements.
95. The IAASB carefully considered the comments received asking for additional guidance recognizing that the requests for increasing or strengthening the application material need to be considered along with comments received regarding the overall length, complexity and readability of the standard. In working through the detailed analysis of the comments, and in its further discussions on the application material, the IAASB sought an appropriate balance, with the objective of ensuring that the application material is clear and understandable, and appropriately supports the application of the requirements.
96. The IAASB also decided not to include Appendix 1 of ED-540, which discussed measurement bases for accounting estimates, in ISA 540 (Revised) as this guidance was considered to be educational in nature and therefore could be placed outside of the standard. The IAASB intends to publish this guidance in connection with the development of other implementation support materials.

Effective Date

Background and Summary of Comments Received on Exposure

97. The Explanatory Memorandum to ED-540 asked respondents whether an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of the final ISA. Respondents were generally supportive of the proposed 18-month transition period from the date of approval of a final ISA. Some of the respondents that were supportive of the proposed 18-month transition period noted that 18 months should be the minimum transition period, given the time needed for translation and due process in various jurisdictions, and that audit firms need sufficient time to implement significant changes to their methodologies. Other respondents indicated that the transition period should be at least 12 months after approval or suggested an effective date for financial reporting periods beginning two years after approval of the final ISA.

IAASB Decisions

98. The IAASB discussed whether ISA 540 (Revised) should be effective for periods beginning on or after December 15, 2018 or December 15, 2019, and concluded that December 15, 2019 would be more appropriate given that:
- As ISA 540 (Revised) affects the planning and risk assessment activities for an audit, the standard would often be implemented nearer the beginning of the period of the financial statements being audited. Given that the final revised standard would be expected to be issued no earlier than September 2018, following approval of due process by the PIOB, an effective date for audits beginning on or after December 15, 2018 would mean that firms and national auditing standard setters would effectively have five or six months for implementation of the standard before the commencement of planning for larger audit engagements (i.e., in early 2019).
 - Firms need time to update their methodologies and audit tools, develop training materials, and train their staff to reflect the changes made to ISA 540 (Revised). The IAASB noted that a short implementation period may result in a rushed or ineffective implementation, which may have

the unintended (and undesired) effect of causing a higher level of negative audit inspection findings.

- Smaller firms often rely on external providers for a “packaged” methodology. An effective date for audits beginning on or after December 15, 2018, may leave insufficient time for the third party to develop such a package for 2019 audits.
- Some national auditing standard setters need time to translate the standard and, in some cases, develop supplemental implementation material based on the translated standard. In some cases, there may also be a need for public exposure of the standard before it will be effective in their jurisdiction.

99. The IAASB agreed that early implementation should be permitted and encouraged given that:

- A significant number of inspection findings related to accounting estimates; and
- Regulators of financial institutions urged the IAASB to have a revised auditing standard on accounting estimates in place to coincide with the effective date of IFRS 9 (January 1, 2018).

To facilitate the commencement of implementation activities the IAASB, with the agreement of the PIOB, made a version of the standard with the final IAASB approved wording available on the IAASB’s website in July 2018, noting that the public release of the revised standard is subject to approval of the due process by the PIOB.

Conforming and Consequential Amendments

Background

100. In the Project Proposal, the IAASB acknowledged that amendments to ISA 500 (in addition to changes in ISA 540) may be needed to clarify the distinction between a third-party pricing source and a management’s expert.
101. In the Explanatory Memorandum to ED-540, the IAASB noted that many entities use external parties as a source of non-pricing related information in preparing the financial statements and concluded that conforming and consequential amendments should also be made for non-pricing data obtained from external information sources. The IAASB was therefore of the view that it would be more appropriate to refer to external information sources instead of third-party pricing sources.
102. The IAASB proposed the following conforming and consequential amendments to ISA 500:
- A definition of an external information source with related application material that explains how an external information source differs from a management’s expert.
 - Specifically including a reference to information obtained from an external information source in paragraph 7, which addresses procedures to consider the relevance and reliability of information to be used as audit evidence.
 - New application material addressing audit evidence considerations related to external information sources. These paragraphs included material regarding factors about the relevance and reliability of information obtained from an external information source, specific material on fair value measurements, and when management and the auditor use the same information source.

Summary of Comments Received on Exposure

103. Generally, respondents were supportive of the proposed intent of the changes and enhanced focus on the consideration of the relevance and reliability of information obtained from an external information source. A few respondents did, however, highlight the possibility of a proposed future project to revise ISA 500 and indicated a preference to defer making changes until the ISA 500 project can consider all potential changes in a more holistic manner.
104. Other comments received primarily focused on:
- The necessity of the change to paragraph 7 in ISA 500, in light of the definition of “audit evidence”;
 - The proposed definition of an external information source and challenges with the term “publicly available”;
 - The clarity and practicality of the proposed new application material in support of the amended requirement in paragraph 7; and
 - The linkage between proposed ISA 540 (Revised) and ISA 500, including the location of certain application material that related more specifically to accounting estimates.

IAASB Decisions

ISA 500, Audit Evidence

105. With respect to the definition of an external information source, the IAASB removed the reference to information being “publicly available” and instead focused on the information being suitable for a broad range of users. In addition, service organizations were explicitly excluded from the scope of the definition to avoid confusion with those services to which ISA 402 applies. Changes were also made to the application material to better explain relevant considerations, and provide examples, in distinguishing an external information source from a management’s expert.
106. With respect to the application material in ISA 500, the IAASB agreed to:
- Clarify in paragraph A1 that information to be used as audit evidence may come from sources internal and external to the entity.
 - Move several paragraphs from ISA 500 to ISA 540 (Revised) (paragraphs A126 to A129) as the IAASB agreed with the view that these paragraphs were specific to accounting estimates.
 - Make clear in the application material when the guidance applies both to when management makes use of an external information source and when an auditor independently obtains information from such a source.
 - Give greater prominence to key challenges in dealing with external information sources, including:
 - Guidance on obtaining an understanding of why management or, when applicable, a management’s expert, uses an external information source (paragraph A33c).
 - The consideration of completeness and accuracy of information from an external information source (paragraphs A33c and A33d).

- Further explanation related to considerations of the relevance and reliability of information obtained from an external information source (paragraph A33d).
- Clarifying in paragraph A33f the implications when there is only one source of information (and hence the auditor can only consider that source alone).

Conforming and Consequential Amendments to Other Standards

107. ED-540 included proposed changes to other ISAs as a result of the changes proposed to ISA 540. Respondents did not raise significant concerns with other conforming and consequential amendments and, accordingly, the IAASB made only minor changes to align with the final text of ISA 540 (Revised). With respect to ISA 230, in addition to the conforming amendment to paragraph A7 described earlier, the IAASB also amended paragraph A10 of ISA 230 to include an additional example of a circumstance related to accounting estimates in which it is appropriate to prepare audit documentation relating to the use of professional judgment.

Post-Implementation Review and Other Activities to Promote Awareness and Understanding and Support Effective Implementation of ISA 540 (Revised)

108. The IAASB intends to undertake a post-implementation review of ISA 540 (Revised). The objective of this review will be to assess if ISA 540 (Revised) has achieved its intended objectives, and to assist the IAASB in, among other matters:

- Understanding whether the standard is sufficiently scalable and whether it enhances the exercise of professional skepticism;
- Identifying implementation challenges and possible areas for improvement within the standard; and
- Considering whether further enhancements to ISA 540 (Revised) are necessary.

109. The post-implementation review may also identify how practical challenges and concerns are being addressed in practice (by auditors, management and audit committees), and whether further enhancements or refinements to the standard, or additional implementation support, are needed.

Implementation Support Activities

110. The IAASB's Steering Committee agreed to form an implementation support working group to perform activities to support awareness, understanding and effective implementation of ISA 540 (Revised). Further information on the working group's activities will be available [on](#) the IAASB's website as it becomes available.

Appendix

PIOB Public Interest Issues Relating to ISA 540

Public Interest Issues	IAASB's Decisions
<p>Better explanation and articulation of risk factors</p> <p>The risk factors need to be clearly explained and articulated in the standard and well supported by application material.</p>	<p>The IAASB has expanded the use of the inherent risk factors in the ISA's risk assessment procedures, and further clarified the inherent risk factors in relevant requirements and application material. Appendix 1 includes an additional discussion of the inherent risk factors relating to accounting estimates and their inter-relationship.</p>
<p>Requirement to understand and test internal controls</p> <p>Auditors should thoroughly understand and test the internal controls around complex accounting estimates and valuation models, particularly for financial institutions. A robust internal control environment is a critical part of an entity's governance system, including how risk is managed by the entity and reported in the entity's financial statements.</p>	<p>The IAASB decided that, for all entities, the ISA should direct the auditor to obtain an understanding of control activities at a more granular level than was the case in ED-540. This is supported by a new requirement to separately assess control risk and by re-emphasizing the requirement in ISA 330 to test controls for significant risks in the current period if the auditor plans to rely on those controls. The ISA also re-emphasizes the requirement in ISA 330 regarding when testing the operating effectiveness of controls is required. Application material includes further guidance to highlight when testing the operating effectiveness of controls may be deemed necessary (e.g., high volume of transactions or data, use of complex model, extensive use of information technology).</p>
<p>Additional expected credit loss specific application material should be included in ISA 540</p> <p>Given that ISA 540 applies to all accounting estimates, additional guidance on auditing complex expected credit loss estimates and valuation models would be helpful for auditors in the banking and insurance industry. Such guidance would help auditors:</p> <ul style="list-style-type: none"> • Understand the entity's business model. 	<p>The IAASB has included material in ISA 540 (Revised) that may be particularly useful when auditing expected credit losses and insurance contract liabilities. This includes addressing (complex) modelling, the need for the auditor to apply specialized skills and knowledge, the use of information from the entity's risk management system, and communications with</p>

BASIS FOR CONCLUSIONS: ISA 540 (REVISED), INCLUDING RELATED
CONFORMING AND CONSEQUENTIAL AMENDMENTS TO OTHER INTERNATIONAL STANDARDS

<ul style="list-style-type: none"> • Assess the classification and nature of financial assets and liabilities. • Audit management’s assessment of credit risk and the consequent accounting estimation, e.g., in “lifetime” expected credit losses. 	<p>regulators or prudential supervisors. The IAASB also included several references to expected credit losses and insurance contract liabilities to emphasize the importance of accounting estimates of this nature, which are generally complex and have high estimation uncertainty.</p>
<p>Auditors should know the applicable regulatory and prudential requirements and practices relevant to accounting estimations – communication with supervisors</p> <p>In addition to “understand regulatory factors,” auditors should be required to provide evidence that the financial institutions comply with the applicable prudential requirements and practices relevant to accounting estimates.</p> <p>Auditors of financial institutions should be required to communicate regularly with supervisors on key issues.</p>	<p>To the extent that applicable prudential requirements are part of the applicable financial reporting framework, the audit of the financial statements would include compliance with the prudential requirements. If not part of the applicable financial reporting framework, the auditor may be required to report on relevant matters in the Other Reporting Responsibilities section of the auditor’s report.</p> <p>The IAASB highlighted in the requirements in ISA 540 (Revised) that, in certain circumstances, the auditor is required by law or regulation to communicate about certain matters with regulators and prudential supervisors.</p>
<p>Early adoption</p> <p>The PIOB supports early adoption of the ISA by auditors.</p>	<p>The IAASB is permitting and encouraging early adoption of the standard.</p>

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**International Auditing
and Assurance
Standards Board**

529 Fifth Avenue, New York, NY 10017
T + 1 (212) 286-9344 F +1 (212) 286-9570
www.iaasb.org