



Agenda Item 8

Auditing Accounting Estimates

Objective of Agenda Item

To provide an overview of the International Auditing and Assurance Standards Board's (IAASB) proposed International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* (ED 540).

The proposals set out in ED 540 are expected to change audit practice. Because the ASB uses the ISA as a base, it is important to solicit the ASB's input while the proposed standard is in exposure in order to identify any significant issues that the ASB may have from a convergence perspective. The views and thoughts from the ASB will be considered by the Estimates Task Force in drafting the ASB comment letter. The comment period ends August 1, 2017. Depending on the extent of ASB feedback during this discussion, or task force concerns, we may request further feedback at the July meeting, prior to submitting our comment letter.

The ED 540 explanatory memorandum is very helpful in highlighting the most significant matters of ED 540. This ASB discussion will focus on those matters and the related requirements of the proposed ISA, specifically with an eye on how it may affect any revision to US generally accepted auditing standards.

ED 540 contains specific questions which the IAASB is seeking feedback from responders. These questions are reproduced in the Appendix to this Issues Paper. The questions are useful in terms of framing and formulating the comments.

Task Force members are:

- Ilene Kassman—KPMG (Chair)
- Dora Burzenski—Deloitte (also a member of the ISA 540 task force)
- Doug Bennett—BKD
- Laura Schuetze—GT
- Rick Fingerett—E&Y

- Mike Lundberg—RSM
- Jon Orkin—PwC (supported by Kathy Healy)

Mike Santay is an observer.

Background

On April 19, 2017, the IAASB released ED 540. As indicated in the ED 540 Explanatory Memorandum, an objective of the proposed ISA 540 is to address auditing challenges arising from the new international accounting standard, IFRS 9, *Financial Instruments* (will be effective for annual periods beginning on or after January 18, 2018). Other objectives are to address issues identified during the post implementation of the IAASB's clarified ISAs and during outreach undertaken by the IAASB. Specifically, there has been significant criticism of auditors' response to risk associated with all estimates when considering the auditor's understanding of management's understanding of the accounting estimates, professional skepticism, and evaluation of controls – including use of technology.

Significant Proposals in ED 540

The following outline summarizes the most significant matters proposed and will serve as the ASB's discussion guide. The outline below highlights the topics, but will require members to also read the identified paragraphs of ED 540. ASB members are welcome to express their views on these issues or any other aspects of ED 540 that the ASB member considers to be significant.

1. *Enhanced approach to Risk Assessment* (ED 540, pars. 10)
 - a. Paragraph 10(b) will require the auditor an understanding of the regulatory factors, if any relevant to accounting estimates.
 - b. Paragraph 10(c), which requires the auditor to obtain an understanding of the nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements.
 - c. Paragraphs 10(e)(i) and A26–A31, which give greater emphasis to the obtaining an understanding of the use of models
 - d. Paragraph 10(e)(iii), which requires the auditor to obtain an understanding of the process used to select data, including the source(s) of that data and how management identifies significant data (both internal and external data)
 - e. Paragraph 10(f), which requires the auditor to obtain an understanding of each of the components of internal control

The proposed ISA introduces three new factors that are intended to influence the assessment of the risk of material misstatement associated with an estimates' estimation uncertainty. The factors are (ED 540, pars. 13):

- a. Complexity
- b. Use of Judgment
- c. Estimation Uncertainty

Questions for Consideration

- The ED 540 is not aligned with the ISA 315 project. Some are concerned that a second set of audit risk criteria have been created that are not aligned with 315. What do ASB members think?
- An underlying current of the ED 540 is data integrity (particularly using forward looking information) and the importance of considering internal controls particularly with regard to auditing estimates. Do ASB members think this is appropriate without changes to 315 or 330 regarding understanding control activities or responses to assessed risks?

2. *Significant Risks*—The IAASB decided to eliminate the extant ISA 540 specific requirements for significant risks. Instead, significant risks are included under the risk factors driven approach discussed. The result is that more work will be required for all estimates.
3. *Work Effort* (ED 540, pars. 14-20)
 - In applying ISA 315, the auditor will be required to make an assessment of inherent risk specific to the estimate and the response has to be specific to the assessed risk.
 - When inherent risk is low, the auditor may perform one or more of the following procedures
 - Subsequent events testing
 - Testing how management made the accounting estimate and the data on which it is based
 - Developing a point estimate or range
 - Test operating effectiveness of controls if the auditor intends to rely on controls or if substantive procedures alone cannot provide sufficient appropriate audit evidence
 - When inherent risk is not low, design and perform further audit procedures to obtain audit evidence about certain objectives related to one or more of the following factors, if an element of the assessed risk:
 - Complexity
 - The need for the use of judgment by management and

- Estimation uncertainty

Questions for Consideration

- Is it reasonable to require inherent risk assessment when rest of standards refer to risk of material misstatement?
- Is there sufficient guidance in other standards to understand how to assess inherent risk along a spectrum? Is it implied?
- Term “low” is very prescriptive. Firms use various schemes to label the risk of material misstatement, for example, some firms use numeric schemes.
- AU-C 200 allows the auditor to make a combined assessment of risk of material misstatement. This proposal will force a separate assessment of inherent risk. If that is the case, a conforming amendment to AU-C 200 is needed. Is the bar too low, recognizing intent was to require more audit response than when a significant risk is assessed? (scalability is an issue the ISA tried to address)
- With regard to scalability – should it be size of entity or risk of the estimate irrespective of size of entity.
- Is there sufficient guidance to direct work effort, meaning – does the auditor choose the most significant factor affecting the risk assessment? Recognizing that the definition of the estimate includes estimation uncertainty.
- Do we think it is clear that not all objectives need to be achieved (related to complexity, judgment, and estimation uncertainty)?
- Is it clear that that evidence related to other assertions would still need to be obtained? For example, recalculation only appears as an objective of complexity but it may be a relevant assertion. (note that ED 540 refers to the estimate as an “account” but is silent to identification of the relevant assertions)
- How do these factors relate to the overall procedures when inherent risk is low? Are the two approaches mutually exclusive? Would an auditor be able to perform a combination of the procedures when the inherent risk is low and the procedures when is not low?
- Paragraphs A.72 and .A73 includes examples of where the risks of material misstatement may be influenced by inherent risk that is low and not low, respectively. Do we believe that the inclusion of these examples may create defacto rebuttable presumptions?

4. Use of an Auditor’s Point Estimate or Ranges—Under extant 540, if the auditor concludes that it is appropriate to use an auditor’s range, extant ISA 540 requires the auditor to “narrow the range,” based on the audit evidence available, until all outcomes in the range are considered reasonable. 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 is inappropriately wide and agreed not to retain this approach. If the auditor concludes that it is appropriate to develop an auditor’s range, paragraph 20 requires the auditor to include in that range only amounts that:

- a. Are supported by the audit evidence; and
- b. The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.

Questions for Consideration

- Do we think the language is sufficiently clear to for auditors to understand there is an intended change in practice?
- Is it clear how it would be consistently applied between those low (develop a point estimate or range) and when part of evaluating estimation uncertainty?

5. *Stand Back* (ED 540, pars. 13-20)—The auditor will be required to evaluate whether the risk assessment remains appropriate, sufficient appropriate audit evidence has been obtained, and management’s decisions related to the recognition, measurement, presentation and disclosure are in accordance with the framework.
6. Use of the Term “Reasonable”—The word “reasonable” is used in both extant ISA 540 and ED-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. 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.
7. *Conforming and Consequential Amendments*—Among other things, the IAASB proposes conforming amendments to ISA 500, *Audit Evidence*. The following is a summary of the proposed conforming amendments to ISA 500:
 - A definition of an external information source (see paragraph 5cA of ISA 500) with related application material that explains how an external information source differs from a management’s expert (see paragraphs A1A-A1C of ISA 500).
 - Specifically including external information sources in paragraph 7 of ISA 500.
 - New application material addressing audit evidence considerations related to external information sources (see paragraphs A33A-A33H of ISA 500). These paragraphs include 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.

Questions for Consideration

- Are there likely unintended consequences of making these changes now?
- Are these conforming or somewhat fundamental that should wait for ISA 500, Audit Evidence project?

Items Presented

Agenda Item 8 – Issues Paper

Agenda Item 8A – ISA 540 (Revised) Exposure Draft

Ms. Kassman will refer to the Issues Paper (Item 8) and the requirement paragraphs 10 – 23 of the proposed ISA 540 (Revised) in leading the discussion. (Beginning on page 24 of the printed version)

Appendix

Overall Questions

- 1) Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?
- 2) Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?

Focus on Risk Assessment and Responses

- 3) Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?
- 4) When inherent risk is not low (see paragraphs 13, 15 and 17–20):
 - a) Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?
 - b) Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?
 - c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?
- 5) Does the requirement in paragraph 20 (and related application material in paragraphs A128–A134) appropriately establish how the auditor’s range should be developed? Will this approach be more effective than the approach of “narrowing the range”, as in extant ISA 540, in evaluating whether management’s point estimate is reasonable or misstated?
- 6) Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate?

Conforming and Consequential Amendments

- 7) With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?

Request for General Comments

8) In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

Auditing Accounting Estimates
ASB Meeting, May 15-18, 2017

EXPLANATORY MEMORANDUM TO ED-540

19

(a) Translations—Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-540.

(b) Effective Date—Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

Invitation for Field Testing

The IAASB recognizes that the significance of accounting estimates to audits of all types of entities may make the impact of this ED particularly significant for audit practices. Accordingly, the IAASB welcomes field testing of the proposals by auditors of all different sizes and in relation to auditing different estimates (i.e., subject to varying degrees of complexity, judgment, and estimation uncertainty).

Interested auditors should contact Brett James, IAASB Deputy Director, at brettjames@iaasb.org for further information on the field testing information package.