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AUDIT 04/20

ISA 540 (REVISED) AUDITING ACCOUNTING ESTIMATES AND DISCLOSURES

Objective

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Effective for periods beginning on or after 15 December 2019

The need for a revised ISA on accounting estimates came about due to the ever increasing complexity in businesses environment as well as financial reporting frameworks (ex. IFRS 9 & 15) together with increased public expectation for the auditor to be more sceptical with respect to judgement areas in the audit. The revisions made to ISA 540 were tailored around these principles and resulted in a more thorough risk assessment process and enhanced documentation for the auditor.

This standard has linkages to the below standards and expands further how these should be applied in relation to accounting estimates:

- ISA230 – Audit Documentation;
- ISA315 (revised) – Identifying and Assessing the Risk of Material Misstatement (effective for periods beginning on or after 15 December 2021);
- ISA330 – The Auditor’s Responses to Assessed Risks;
- ISA450 – Evaluation of Misstatements Identified during the Audit; and
- ISA500 – Audit evidence.

Risk Assessment: Introduced the concept of inherent risk which is more prescriptive (par.13-17)

- ◇ Inherent risks are characteristics of conditions and events that may affect the susceptibility of an assertion to misstatement before consideration of controls such as:
 - Estimation uncertainty;
 - Complexity;
 - Subjectivity; and
 - Susceptibility to management bias/ fraud
- ◇ Separate assessment of inherent risk and control risk is required;
- ◇ Enhanced risk assessment procedures relating to obtaining an understanding of the entity and its environment, including the entity’s internal control are required;
- ◇ Scalability of the audit work is to be carried out based on the risk assessment process.

Internal Controls: Emphasized the importance of the auditor’s decision about controls relating to accounting estimates (par.19-20)

- ◇ Risk assessment procedures relating to obtaining an understanding of the entity and its environment, including the entity’s internal control were enhanced in ISA 540 (Revised). For instance, additional requirements for the auditors to identify control activities (including IT controls, where applicable) relevant to the audit over management’s process for making accounting estimates have been added.
- ◇ In line with ISA 315, testing the operating effectiveness of controls is required if there is an expectation that the controls are operating effectively, or substantive

procedures alone cannot provide sufficient appropriate audit evidence at the assertion level

- ◇ In cases where controls are not being relied on and a substantive approach is being adopted, the standard gives some examples of tests of detail for accounting estimates:
 - Examination, for example, examining contracts to corroborate terms or assumptions.
 - Recalculation, for example, verifying the mathematical accuracy of a model.
 - Agreeing assumptions used to supporting documentation, such as third-party published information.

Work effort: Introduced objectives-based work effort requirements depending on the risk of material misstatement involved (par.22-30)

- ◇ The auditor's effort on testing management's accounting estimates should be targeted on:
 1. The selection and application of methods used – whether the method used is appropriate, assessment of changes from the method used in the prior year, when different methods give a wide range of results consideration as to whether management has investigated the differences, whether calculations are mathematically correct.
 2. The appropriateness and consistency in significant assumptions – management's rationale for the assumptions used, assessment of any changes in assumptions from the prior year, any possible management bias, review of assumptions taken in the past taking into account with information subsequent to year end, consistency with other judgements used in other areas of the business based on the knowledge obtained from the audit; and
 3. The appropriateness, relevance and reliability of data used – management's rationale for the data used, testing the reliability of the data used in accordance with ISA500, assess whether data has been appropriately interpreted by management.
- ◇ Strengthened the requirement that when management has not appropriately understood or addressed estimation uncertainty the auditor is still required to comply with the requirements of ISA500 (Audit evidence);
- ◇ Enhanced approach for developing an auditor's range – the use of the auditor's own assumptions in developing a range to evaluate the reasonableness of management's point of estimate. The auditor should obtain audit evidence that the points at both ends of the range are reasonable in the circumstances, thereby concluding that the amounts falling between those two points are reasonable (paragraphs 28-29).

Documentation: More documentation on audit files is required (paragraph 39);

- ◇ The key elements of the auditor's understanding of the entity and its environment, including internal control relating to accounting estimates;
- ◇ The linkage of further audit procedures with the assessed risk of material misstatement at the assertion level;
- ◇ The response to situations where management has not taken appropriate steps to understand and address estimation uncertainty;
- ◇ Indicators of possible management bias, if any, and the auditor's evaluation of the implications for the audit; and
- ◇ Significant judgments made in the determination of whether the accounting estimates and related disclosures are reasonable, or are misstated, in the context of the applicable financial reporting framework.

Other enhancements:

- ◇ Disclosures: Changed the objective of the standard "to obtain sufficient appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements..." from adequate to reasonable; (par.11)
- ◇ Enhanced the "stand-back" approach by the auditor whereby an evaluation of the audit evidence obtained regarding the accounting estimates, whether corroborative or contradictory in nature, is taken into account during the evaluation process; (par.33-36)
- ◇ Emphasized requirement when communicating with those charged with governance;
- ◇ Enhanced the auditor's exercise of professional scepticism through the use of stronger language such as "challenge", "question", "reconsider" in the application material in addition to other concepts mentioned above.

Under the revised ISA540 auditors need to understand the requirements properly before they are able to make a judgement about what work they need to perform on accounting estimates, hence the risk assessment's importance has increased. Similarly, more emphasis should be attributed to the work effort of the auditor, which has become more prescriptive. Finally, the documentation on audit files should be more robust to demonstrate all the effort of auditors (including demonstrating professional scepticism) to tackle areas which in their nature are judgmental, presenting challenges to audit and at the same time becoming much more relevant for investors and other users of the financial statements.