



Subject: Agenda for the 89th meeting of the AUASB
Venue: Executive Board Room
Tertiary Education Quality and Standards Agency (TEQSA) offices
Tower Level 14, 530 Collins Street Melbourne
Time: Teleconference: Tuesday, 07 March 2017 from 10.00am. to 12.00pm.

Time	Agenda Item No.
10.00am	1. ISA 540 Auditing Estimates, Including Fair Value Accounting Estimates and Related Disclosure
10.45am	2. ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding One Entity and its Environment
11.15am	3. Professional Scepticism
11.25am	4. Quality Control - EQCR
11.40am	5. SMP / SME Audits (subject to papers being received)
11.55am	6. IESBA Co-ordinator
12.00pm	Close

Agenda Item 2-A

ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* – Issues and Task Force's Recommendations

Objective of the IAASB Discussion

The objective of this agenda item is to approve the issuance of draft proposed ISA 540 (Revised) for exposure.

Introduction

1. Since the December 2016 IAASB meeting and January 2017 IAASB teleconference, the Task Force has made further changes to draft proposed ISA 540 (Revised) in response to the comments made by the IAASB, further deliberation by the Task Force on matters raised by the IAASB, and other changes to clarify and simplify the ISA. The marked draft of proposed ISA 540 (Revised) in **Agenda Item 2-B** reflects these changes. The clean version (**Agenda Item 2-C**) will be used as the basis for the IAASB's discussion. An extract of the IAASB's September 2016 discussions is available in Appendix 2 to this paper.
2. This paper covers the major changes proposed by the Task Force. It is organized as follows:
 - Section I: Introduction, Objective and appendices;
 - Section II: Risk Assessment;
 - Section III: Work effort;
 - Section IV: Other matters;
 - Section V: Conforming and consequential amendments; and
 - Appendix: Possible matters to address in the Explanatory Memorandum (EM).
3. The changes proposed by the Task Force are intended to improve the clarity of the requirements, provide sufficient application material to support consistent application of the requirements, and to remove redundant or unhelpful material that added complexity without providing clarity. The Task Force remains open to considering further changes to enhance the clarity, understandability, and practicality of the ISA.

Matter for IAASB Consideration

1. Are the requirements clear, understandable, and capable of practical application?

Section I – Introduction, Appendices, and Objective

Overview of Changes

4. The Task Force redrafted the Introduction section of ISA 540 to:
 - Introduce the factors of complexity, judgment and estimation uncertainty, given their importance to identifying, assessing and responding to risks of material misstatement (ROMM); and

- Highlight the key concepts of the ISA, including the importance of professional skepticism to the auditor's work on accounting estimates and the risk of management bias.

The revised introduction is supported by two new appendices as described below.

5. The "key concepts" section (paragraphs 3A–4) also refers to the requirement for the auditor to perform an overall evaluation of whether the accounting estimates are reasonable, a concept that is fundamental to the ISA as noted in the objective of the standard (see further discussion below).
6. The Task Force aligned the concepts and improved the flow and terminology used in the standard. Based on the auditor's understanding of the entity and its environment obtained by the auditor in accordance with paragraph 8, paragraph 10 requires the auditor to take the factors described above, and any other relevant factors, into account when identifying and assessing the ROMM related to an accounting estimate. Section III below describes the auditor's response to the ROMM.

Appendix 1

7. Appendix 1 discusses different types of measurement bases and how they affect making accounting estimates. The appendix provides examples of how different bases affect the measurement of accounting estimates. The Task Force was of the view that showing the variety of measurement bases will help the auditor understand the extent of accounting estimates in the financial statements and how different measurement bases might contribute to the factors of complexity, judgment and estimation uncertainty. The IASB staff have been asked to comment on this appendix.

Appendix 2

8. Appendix 2 provides further background on the factors of complexity, the need for the use of judgment by management, and estimation uncertainty. Although these factors have not changed in substance since the last IAASB discussion, the Task Force was of the view that a further understanding of each of the factors would be helpful because of their importance to the auditor's identification and assessment of, and response to, risks of material misstatement.

Objective

9. The Task Force proposed a change to the objective of ISA 540. In extant ISA 540, the auditor's objective uses the term "adequate" for disclosures but "reasonable" for accounting estimates (see paragraph 6 of **Agenda Item 2-C**). The Task Force's research showed that the view of the IAASB that led to the use of "adequate" in extant ISA 540 was due to a differing view of what was achievable for disclosures. The Task Force believes that continuing to use "adequate" may suggest that disclosures are somehow less important than the accounting estimate itself. Accordingly, the Task Force concluded that both the accounting estimate and the related disclosures should be "reasonable" in the context of the applicable financial reporting framework.
10. Some Task Force members questioned whether the term "reasonable" is a sufficiently high threshold. It was noted that the subjective nature of the word "reasonable" may not adequately promote, and could undermine, the exercise of professional skepticism. The Task Force considered several alternative approaches, before concluding that "reasonable" would be most appropriate provided that guidance was included as to its meaning. The Task Force therefore decided to explain in the key concepts section (paragraph 4) that reasonable goes beyond compliance with the requirements of the financial reporting framework and provided guidance in the application material (paragraph A1B

and A1C) regarding factors that may be relevant to the auditor's evaluation of whether the accounting estimates and related disclosures are reasonable.

Matters for IAASB Consideration

2. The IAASB is asked for its views on:
 - (a) The introduction section, including the new appendices; and
 - (b) The changes to the objective.

Section II – Risk Assessment

11. The Task Force made changes to the risk assessment section of the ISA, particularly to enhance the requirements for obtaining an understanding of various elements relating to accounting estimates, and to better align the understanding with the requirements for identifying and responding to the risks of material misstatement. The main changes are:
 - Added requirement (paragraph 8(c)(aA)), and related application material, for the auditor to obtain an understanding of the regulatory factors relevant to accounting estimates. The Task Force was of the view that this requirement enhances the standard as obtaining an understanding of the regulatory factors may:
 - Assist the auditor in determining whether there are disclosures required in addition to the requirements of the applicable financial reporting framework;
 - Provide the auditor with an indication of areas for which there may be a potential for management bias in meeting regulatory requirements; and
 - Address conditions for the recognition, or methods for the measurement, of accounting estimates, or provide related guidance thereon.
 - Added requirement for the auditor to obtain an understanding of how management identifies and addresses the risk of management bias (paragraph 8(c)(iiiA)).
 - Replaced the term 'data and assumptions to which the accounting estimate is particularly sensitive to' with the term 'significant data and assumptions.' In the version of ISA 540 discussed with the Board in December, the notion of data and assumptions to which the accounting estimate is particularly sensitive was included in paragraph 8(c)(iv). The Task Force was of the view that the term significant data and assumptions was more concise. The term is explained in paragraph A35A.
12. The Task Force also expanded the application material related to paragraph 8. For example, application material was added to explain how inactive or illiquid markets may influence assumptions (paragraphs A35B and A35C). The Task Force further enhanced the application material related to the following requirements:
 - Obtaining an understanding of managements' method to make the accounting estimate (paragraph 8(c)(i));
 - Obtaining an understanding of the assumptions management uses to make the accounting estimate (paragraph 8(c)(ii)); and

- Obtaining an understanding of the data that management uses to make the accounting estimate (paragraph 8(c)(iiA));
 - The components of internal control as they relate to accounting estimates (paragraph 8(d)).
13. Based on the comments received during the December Board meeting, the Task Force enhanced the application material to paragraph 9 by clarifying the objective of the retrospective review and explaining when performing a retrospective review would not be useful.
14. The Task Force acknowledged the broad support for the factors that may give rise to the ROMM (that is, complexity, judgment, and estimation uncertainty) but that further clarification would make the requirements more capable of consistent application in practice. In light of this, the Task Force made changes to paragraph 10 and the associated application material (paragraphs A44F–A49C) to further explain these concepts and to show how they are to be applied in practice.

Matter for IAASB Consideration

3. The IAASB is asked for its views on the revisions to the risk assessment section of proposed ISA 540 (Revised) (paragraphs 8-10 of **Agenda Item 2-C**).

Section III – Work Effort

15. The Task Force has taken into account comments from the IAASB and the IAASB Consultative Advisory Group (CAG) about improving the clarity and simplicity of the ISA's work effort, while continuing to seek improvements to aspects of the work effort, such as a renewed focus on highlighting when controls testing is needed. At the December 2016 IAASB meeting, the Task Force presented a revised approach to the work effort, which the IAASB generally supported.

Application of the Threshold

16. The Task Force noted the IAASB's overall support for the approach to setting a threshold for the detailed work effort based on the level of the assessed ROMM. Accordingly, the Task Force resolved that only limited changes should be made to paragraph 13 and its application material. These changes include:
- Clarifying in the application material that when assessed ROMM is low, but not because that assessment includes an expectation that relevant controls are operating effectively, the auditor's assessment of ROMM is primarily influenced by inherent risk; and
 - Referring to both substantive procedures and tests of controls in paragraph 13(c).
17. The Task Force noted the comments at the December 2016 IAASB meeting about whether some firms' methodologies would permit them to assess ROMM as low without testing controls (in other words, the methodology may not allow for an assessment of ROMM as low, even with lower inherent risk, unless the auditor expected controls to be operating effectively and planned to test them). After further discussing this issue, the Task Force decided not to make further changes to paragraph 13, and acknowledged that changes to firm methodologies likely will be needed when ISA 540 (Revised) is issued.

18. Other changes made or considered included:

- The phrase “when applicable” was added to both paragraphs 13(b) and 13(c) in relation to the requirement to obtain audit evidence about the matters in paragraph 13A–13C. These words, together with the conditionality present in 13A–13C (i.e., the use of the word “when”) indicate that the auditor only needs to obtain audit evidence about the matters when the condition is present.
- The Task Force discussed the usage of the phrase “if the assessed risk of material misstatement is low, **but not because** that assessment includes an expectation that relevant controls are operating effectively” in paragraph 13(a) of Agenda Item 2-C. While some on the Task Force would have preferred the wording in paragraph 13(b) (“...**and that assessment...**”), the Task Force concluded that the word “but” was needed to signal that the assessment of the ROMM was not dependent, in any way, on the auditor’s expectations regarding relevant controls.

The Auditor’s Work Effort in Response to Complexity, Judgment, and Estimation Uncertainty

19. In light of the general support provided by the IAASB at the December 2016 IAASB meeting, the Task Force continued to refine and develop the “objectives-based” work effort approach as shown in paragraphs 13A–13C. The major changes to these sections are:

- *Complexity* (paragraph 13A):
 - Reorganized paragraph 13A to require the auditor to obtain sufficient appropriate audit evidence about each of the matters when complexity is identified as a reason for the assessed ROMM.
 - Rephrased the requirements in 13A(a)-(e) to better communicate the Task Force’s intentions, including requirements addressing whether the integrity of the significant data and assumptions has been maintained, and better linking this requirement to the concept of “significant data and assumptions” as used in the risk assessment section.
- *Judgment* (paragraph 13B):
 - Reorganized the requirement to provide a more logical flow, and reorganized the application material accordingly.
 - Added a new requirement about whether the significant assumptions are consistent with those used in other accounting estimates or other areas of the business.
 - Enhanced the application material on model adjustments in light of stakeholder input on the importance of appropriate management judgments when making adjustments to the output of a model.
- *Estimation Uncertainty* (paragraph 13C):
 - Revised the requirement extensively to give a more logical flow so that:
 - Paragraph 13C(a) addresses when management has taken appropriate steps to understand and address estimation uncertainty; and
 - Paragraphs 13C(b) and 13C(c) address when management has not appropriately addressed the effect of estimation uncertainty.

- Changed the focus of the requirement in 13C(c) from “narrowing” the auditor’s range (which may be seen as implying that it is satisfactory for the auditor to start with an unreasonably wide range, and only then seek to narrow it until all points within the range are reasonable) to only including in the auditor’s range amounts that are supported by the audit evidence and that the auditor has evaluated to be reasonable in the context of the applicable financial reporting framework. See also paragraph 25 below.
20. The Task Force discussed the application material regarding ranges and noted that there may be concerns about whether auditors are always capable of developing a range that is sufficiently precise as to be useful. However, the Task Force concluded that the development of a range is still an available audit strategy when the auditor concludes management has not appropriately addressed the effects of estimation uncertainty in an accounting estimate, and it is often a necessary step when the audit evidence does not support only one point estimate. Accordingly, the Task Force made only limited changes to the application material in A60C to A60M.

The Stand Back Provision

21. The Task Force made changes to paragraph 13E in response to the IAASB’s comments at the January 2017 IAASB teleconference.
22. The changes included making clear that the stand back provision only applies to those accounting estimates for which the auditor performed procedures to address the matters in paragraphs 13A-C (in other words, for those estimates for which the reasons for the assessment given to the ROMM included one or more of the factors of complexity, judgment or estimation uncertainty). This change is intended to focus the auditor’s stand back actions on those estimates with a higher risk of material misstatement, rather than for all accounting estimates.
23. Changes also were made to make the link with ISA 330 more explicit (including reference to the ROMM at the assertion level), and to include a reference to indicators of possible management bias in the stand back requirement. This is supported by revised application material to explain the link with ISA 330 and to provide an example of how the stand back provision may operate. (See paragraphs A121B–A121D).

Evaluating the Reasonableness of Accounting Estimates, and Determining Misstatements

24. In response to the IAASB’s comments at the January 2017 IAASB teleconference, the Task Force amended the order of the requirement in paragraph 13F so that it better aligns with extant ISA 540. The Task Force added a sentence regarding the consideration of all relevant audit evidence obtained, whether corroborative or contradictory, as requested by some Board members to make the evaluation stronger and to improve the focus on the application of professional skepticism.
25. The Task Force noted that the application material supporting this paragraph provides guidance for the auditor in evaluating whether an accounting estimate is misstated and whether the audit evidence supports an auditor’s point estimate or a range. The Task Force further discussed how the auditor would determine the amount of a misstatement when the audit evidence supports a range that does not encompass management’s point estimate, and in particular when the range is wide (see paragraph A121G). This led to discussion about whether ISA 540 should continue to permit auditors to develop ranges in response to management’s failure to adequately address the effects of estimation uncertainty. The Task Force concluded that it would be best to maintain the approach in extant ISA 540 (which permits the development of ranges), but that:

- The requirement in paragraph 13C(c) should be focused on only including in the range amounts that are supported by audit evidence and that the auditor has evaluated to be reasonable in the context of the applicable financial reporting framework; and
- The development of auditor's point estimates or ranges (including the amount of a misstatement when the audit evidence supports a range that does not encompass management's point estimate) should be addressed in the Explanatory Memorandum to the exposure draft so that stakeholders have an opportunity to comment (see Appendix).

Matter for IAASB Consideration

4. The IAASB is asked for its views on the paragraphs 13–13F of **Agenda Item 2-C**.

Section IV - Other Matters

26. In addition to the above changes, the Task Force has proposed other changes to respond to matters raised during the outreach, discussions with the IAASB or CAG, or during the Task Force's own deliberations. In brief, these include:
- (a) Management bias (paragraph 21) – In addition to specific material addressing management bias in paragraphs 13A-13C and 13E, the Task Force has also clarified in paragraph 21 that when indicators of possible bias are identified, the auditor needs to evaluate the implications for the audit.
 - (b) Written representations (paragraph 22) – The existing requirement on written representations has been supplemented by an additional requirement to consider whether representations are needed about specific accounting estimates (including with respect to the method used to make the accounting estimate).
 - (c) Communication with those charged with governance or management (paragraph 23) – This requirement has been expanded slightly to also cover communications regarding significant deficiencies in internal control. This is supported by application material (paragraph A121B).

Effective Date

27. The IAASB's usual practice is to set an effective date of a new ISA approximately 18–24 months after the final standard is issued. This delay allows time for firms to change their audit methodologies and for training to take place.
28. The Task Force notes that it may be desirable for ISA 540 (Revised) to be effective as soon as possible, given the effective date of IFRS 9 and requests by regulators and others to enhance ISA 540 as soon as possible. Given the extent of changes from the extant ISA, and to allow sufficient time for practitioners to make the necessary preparations, including with respect to methodologies and training, the Task Force recommends that the normal 18–24 month implementation period be maintained. The Task Force also believes that early adoption should be permitted and encouraged.

Matter for IAASB Consideration

5. What views does the IAASB have on the proposed effective date of ISA 540 (Revised)?

Section V – Consequential and Conforming Amendments

29. The Task Force made limited consequential and conforming amendments to ISA 260 (Revised),¹ and ISA 580,² and more significant amendments to ISA 500³ with respect to external information sources. The amendments are included in **Agenda Item 2-D**.
30. The Task Force made several changes to ISA 500 since the December 2016 meeting with the goal of clarifying the Task Force's intention with respect to external information sources. The main changes are:
- Made amendments related to external information sources to paragraph 7 instead of paragraph 9 of ISA 500. The Task Force noted that paragraph 9 requires the auditor to evaluate the reliability of the information used but not the relevance. It was also noted that in some instances the auditor may not always be able to meet the detailed requirement in paragraph 9(a) of ISA 500 regarding the accuracy and completeness of the information, for example when there is no contractual relationship requiring provision of information between the external information source and the entity. The Task Force therefore concluded that the application material could be better linked to paragraph 7 of ISA 500 given that it is the overarching requirement and it refers to both the relevance and reliability of the audit evidence;
 - Included application material addressing instances when the auditor may not be able to consider the accuracy and completeness of the information received from an external information source (paragraph A33C); and
 - Broadened the application material related to external information sources by including examples that are not pricing-related.

Matter for IAASB Consideration

6. The IAASB is asked for its views on the consequential and conforming amendments made to ISA 260 (Revised), ISA 500, and ISA 580.

¹ ISA 260 (Revised), *Communication with Those Charged with Governance*

² ISA 580, *Written Representations*

³ ISA 500, *Audit Evidence*

Appendix 1

Listing of Possible Matters to Address in the Explanatory Memorandum

The Task Force has identified some matters that it believes would be useful to address in the Explanatory Memorandum and on which to specifically seek comments. These include:

- The clarity, understandability and ability to practically apply ISA 540 (Revised). Specifically for small and medium-sized practices, this would include whether the standard is sufficiently scalable, including whether the threshold in paragraph 13 of ISA 540 (Revised) is understandable.
- Whether the requirements and application material will support the application of professional skepticism when addressing accounting estimates.
- Whether the revised work effort is clear, including whether the guidance is clear, concise, and is sufficient to support consistent application in practice.
- Whether there is support for the approach taken to evaluating whether, and to what extent, there is a misstatement of an accounting estimate when dealing with an auditor's point estimate or range. , and whether additional guidance would be helpful.
- With respect to external information sources, whether the IAASB should make the proposed conforming and consequential changes to ISA 500 or whether this issue should be addressed as part of the IAASB's future project on ISA 500.

Matter for IAASB Consideration

7. The IAASB is asked whether there are other matters that should be addressed in the Explanatory Memorandum.

Extract of Minutes – IAASB 2016 December Meeting

ISA 540

Mr. Sharko and Mr. Pickeur introduced the topic by highlighting the objectives of the project to revise ISA 540 and timeline for moving the project forward. They also explained the reasons for seeking approval of the ED in March 2017 instead of December 2016.

INTRODUCTION

Mr. Sharko explained that the ISA 540 Task Force (ISA 540 TF) discussed the Introduction section but that further changes will be made to the application material to explain the key characteristics of accounting estimates, including the factors of complexity, judgment, and estimation uncertainty. The Board generally supported the ISA 540 TF's proposals but suggested consideration of the following:

- Explaining the interaction between ISA 315 (Revised) and ISA 540 in the Explanatory Memorandum to the ED, including the interaction between the factors of complexity, judgment and estimation uncertainty and the four factors that are introduced by the ISA 315 (Revised) Task Force in **Agenda Item 10-A**;
- Limiting the additions to the application material, as it was noted that excessive amounts of guidance can make the introduction section less clear. It was suggested that some of the introduction and related application material could be included in an Appendix to the standard; and
- Adding back the notion of management bias in the Introduction section as it helped to explain the focus of the ISA.

DEFINITIONS AND RISK ASSESSMENT

The Board generally noted support for the definitions and the risk assessment section but asked the ISA 540 TF to consider:

- Including the notion of estimation uncertainty in the definition of an accounting estimate;
- Broadening the reference to data in paragraph 8(c)(iA) and paragraph 8(c)(ii) beyond just external data;
- Simplifying paragraph 8, as some Board members were of the view that the current construct could be seen as complicated and long; and
- Broadening the scope of paragraph 9A and 11A by noting that the auditor should think about whether specialized skills or knowledge are needed throughout the audit rather than just specific phases of the audit. It was suggested to look at the guidance provided by the United States Public Company Accounting Oversight Board (PCAOB).

It was noted that the application material to paragraph 9 could be enhanced by clarifying the objective of the retrospective review and explaining when performing a retrospective review would not be useful. The Board also suggested deleting paragraph 10(d) and including application material that explains that the auditor may also take other factors into account in the assessment of the risk of material misstatement.

WORK EFFORT

The majority of the Board supported a threshold to direct the auditor when the more detailed work effort requirements are mandatory as it was seen to help practitioners navigate through the standard and improve the clarity and understandability of the standard. However, the Board asked that the threshold be made as clear and understandable as possible.

The Board generally supported a requirement in ISA 540 that expands on when substantive procedures alone cannot provide sufficient appropriate audit evidence (option 1 as presented in **Agenda Item 2-A**). This was because it was seen to be responsive to concerns expressed by certain regulators that, without such a requirement, ISA 540 could be seen as lacking rigor regarding the importance of testing the operating effectiveness of controls in certain circumstances.

In addition the Board generally asked the ISA 540 TF to consider:

- Simplifying paragraph 13 and thereby enhancing the readability and understandability of the standard. The Board noted that the current requirement are comprehensive but complex.
- With respect to stand back requirement in paragraph 13D:
 - Whether the requirement should be performed for accounting estimates generally or individually;
 - Emphasizing the importance of professional skepticism in the stand back requirement;
 - Broadening the requirement so that it is based on the audit procedures performed in accordance with ISA 540 instead of just the work effort requirements; and
 - Aligning the requirement more closely with ISA 330⁴ and ISA 570 (Revised).⁵

The Board supported the objective-based approach in paragraphs 13A-C as presented by the ISA 540 TF and provided several suggestions for how to enhance these paragraphs. These suggestions included making certain of the paragraphs more objective based, and clarifying and simplifying other paragraphs.

OTHER MATTERS

The Board had mixed views on whether external information sources should be addressed by the ISA 540 TF or the Working Group that may be formed for a potential project related to Audit Evidence. The majority of the Board supported the ISA 540 TF's view that, as set out in **Agenda Item 2-D**, the ISA 540 TF should address external information sources. In making this decision, the Board noted that any changes to ISA 500 should be limited to external information sources and that the ISA 540 TF should be mindful of the risk of unintended consequences to aspects of the audit not related to accounting estimates. It was also agreed that this matter should be highlighted in the Explanatory Memorandum to be issued with the ED. The Board requested that consideration be given to broadening the application material related to external information sources by including examples that are not pricing-related as the application material presented is heavily focused on pricing services.

The Board also requested consideration of the following other matters in the agenda material:

- Including application material that provides guidance for when the auditor's range is large (such as when the auditor's range larger than performance materiality);

⁴ ISA 330, *The Auditor's Responses to Assessed Risks*

- Evaluating whether all the application material is needed. It was noted that some of the application material could be used in an International Auditing Practice Note (IAPN) on banking specific matters;
- Addressing the remaining matters suggested by the Professional Skepticism Working Group to enhance professional skepticism in auditing accounting estimates;
- Making changes to the requirements to improve the clarity, understandability, and conciseness as some requirements are complex and therefore may lead to confusion and implementation issues; and
- Considering whether all matters included in the project proposal and project update have been addressed.

IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron noted that the standard as presented takes into account suggestions made by CAG Representatives. He furthermore highlighted the importance of having a standard that is understandable and noted that the CAG was generally supportive of approving an ED in March 2017, noting that it is better to approve the ED later in order to get a high-quality standard.

PIOB OBSERVER REMARKS

Prof. Van Hulle reminded the Board that it was important to address the key messages it receives from stakeholders, including the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. To that end, he suggested including more requirements specifically related to models to respond to their comments.

With respect to the work effort, Prof. Van Hulle noted that this section can be perceived as being extremely complex and suggested simplifying the standard by reinforcing a principles-based approach and trying to simplify the language.

WAY FORWARD

The IAASB will discuss ISA 540 again at its teleconference in January, 2017 and its meeting in March 2017. The Task Force intends to present a draft ED for approval at the March 2017 IAASB meeting.

⁵ ISA 570 (Revised), *Going Concern*

Agenda Item 2-B

INTERNATIONAL STANDARD ON AUDITING 540 AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

Marked from December 2016 IAASB Meeting

(Effective for audits of financial statements for periods
beginning on or after December 15, [TBA])

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised),¹ ISA 330,² ISA 500³ and other relevant ISAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

- ~~2. Some financial statement items cannot be measured precisely. For purposes of this ISA, such financial statement items are referred to as accounting estimates. Accounting estimates vary widely in nature, and may be affected by complexity in making the accounting estimate, the use of judgment by management in making the accounting estimate, and estimation uncertainty. The extent to which the accounting estimate is subject to, or affected by, the factors of complexity, judgment and estimation uncertainty affects the auditor's assessment of the risks of material misstatement related to the accounting estimates. Accordingly, this ISA requires that the nature, timing, and extent of audit procedures, in responding to the assessed risks of material misstatement, address the reasons for the auditor's assessment, that is be responsive to the factors present in making an accounting estimate, recognizing that the higher the risk the more persuasive the audit evidence required. (Ref: Para. A1–A10)~~
2. Many financial statement items are susceptible to an inherent lack of precision in their measurement. In the ISAs, such financial statement items are referred to as accounting estimates. Accounting estimates vary widely in nature, and may be subject to, or affected by, complexity, the need for the use of judgment by management, and estimation uncertainty. The extent to which this is the case affects the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor's responses to those assessed risks. (Ref: Para: A1A, Appendix 1, Appendix 2)
3. Accounting estimates may be more susceptible to at risk of material misstatement when:
 - (a) With respect to complexity, management does not:

¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

² ISA 330, *The Auditor's Responses to Assessed Risks*

³ ISA 500, *Audit Evidence*

- (i) Apply appropriate specialized skills or knowledge in the selection, design or application of the method used to make the accounting estimate, including when the method involves complex modelling;
- (ii) Appropriately understand the relevance and reliability of the data used, regardless of whether the data is obtained from internal sources or from external information sources; or
- (iii) Maintaining the integrity of the data used.
- (b) With respect to the need for the use of judgment management does not:
 - (i) Appropriately take into account available information when selecting methods, assumptions, or data; or
 - (ii) Mitigate the risk of management bias; and
- (c) With respect to estimation uncertainty, management does not:
 - (i) Take appropriate steps to address estimation uncertainty; or
 - (ii) Select an appropriate management point estimate or make appropriate related disclosures in the financial statements

Key Concepts Overview of This ISA

- 3A. This ISA focuses the auditor's attention on designing and performing further audit procedures (including, where appropriate, tests of controls) responsive to the reasons for the assessment given to the assessed risks of material misstatement, particularly when those reasons include complexity, judgment or estimation uncertainty. This ISA also recognizes that the factors complexity, judgment or estimation uncertainty are interrelated and that there are inherent limitations in reducing estimation uncertainty beyond certain limits.
- 3B. The application of professional skepticism by the auditor is particularly important to the auditor's work relating to accounting estimates. Professional skepticism also is important because there is a particular risk of management bias affecting accounting estimates, due to their subjective, potentially complex and uncertain nature, and the possible combined effect of complexity, judgment and estimation uncertainty.
- 4. This ISA requires an overall evaluation of accounting estimates based on the audit procedures performed and the audit evidence obtained. In doing so, the auditor is required to evaluate whether the accounting estimates, and related disclosures, are reasonable. For this purpose, the evaluation of reasonableness involves considerations beyond whether the accounting estimate and related disclosures comply with the requirements of the applicable financial reporting framework. (Ref: Para. A1B–A1C).
- ~~4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. For example, for fair value accounting estimates, any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements, and this is also true for other types of accounting estimates.~~

Effective Date

5. This ISA is effective for audits of financial statements for periods beginning on or after [TBA].

Objective

6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:
- (a) Accounting estimates, whether recognized or disclosed,—in the financial statements, ~~whether recognized or disclosed, are reasonable~~; and
 - (b) Related disclosures in the financial statements ~~are adequate~~,
are reasonable in the context of the applicable financial reporting framework.

Definitions

7. For purposes of the ISAs, the following terms have the meanings attributed below:
- (a) Accounting estimate – A monetary amount, prepared in accordance with the requirements of the applicable financial reporting framework, the measurement of which is subject to estimation uncertainty~~cannot be made with certainty~~. (Ref: Para. A11A)
 - (b) Auditor's point estimate or auditor's range – An amount, or range of amounts, respectively, developed by the auditor in evaluating management's point estimate. (Ref: Para. A11B)
 - (c) Estimation uncertainty – The susceptibility of an accounting estimate to an inherent lack of precision in its measurement. (Ref: Para. A11C)
 - (d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A11D)
 - (e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
 - (f) Outcome of an accounting estimate – The actual monetary amount that~~which~~ results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para A11E)

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including its internal control, as required by ISA 315 (Revised),⁴ the auditor shall obtain an understanding of the following: (Ref: Para. A12)
- (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including the recognition criteria, measurement bases and the related presentation and disclosure requirements. (Ref: Para. A13–A15)

⁴ ISA 315 (Revised), paragraphs 5–6 and 11

(aA) Regulatory factors relevant to accounting estimates.⁵ (Ref: Para. A15A–A15C)

(aBbA) The nature of the accounting estimates ~~and the related disclosures that the auditor expected to be included~~ in the ~~entity's~~ financial statements, ~~including the sources and extent of complexity and estimation uncertainty, and the judgment needed to make the accounting estimates.~~ (Ref: Para. A15D–A15E)

(b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16–A21)

(c) How management makes accounting estimates, including: (Ref: Para. A22–A23)

(i) The methods used ~~in making the accounting estimates~~, how ~~the methods have been~~ they are selected or designed, and how they are applied, including the extent to which they involve complex modelling and, where applicable, how models have been used; (Ref: Para. A23A–A26)

(ii) The process used to select assumptions, including used alternatives considered and how management identifies significant assumptions to make the accounting estimates, including whether assumptions have been developed using data from external sources; (Ref: Para. A26A–A35D)

(iiA) The process used to select data on which the accounting estimates are based, including the source(s) of that data and how management identifies significant data, including whether data has been obtained from external sources, how management evaluates the relevance and reliability of those sources and the processes applied in obtaining the data; (Ref: Para. A35E–A35H)

(iii) The extent to which ~~Whether~~ management has applied specialized skills or knowledge, including whether a management's expert has been used ~~an expert~~; (Ref: Para. A35I–A35J)

(iiiA) How the risk of management bias is identified and addressed; (Ref: Para. A35K)

(iv) How management has addressed estimation uncertainty; and (Ref: Para. A38);

~~including the extent to which management has evaluated which data and assumptions the accounting estimate is particularly sensitive to and therefore have the greatest impact on the accounting estimate; and (Ref: Para. A38–A38A)~~

(vi) Whether management has addressed the need for there has been, or ought to have been, a change from the prior period in the methods, assumptions or data used for making the accounting estimates, and if so, the nature of, and reasons for, such changes and why. (Ref: Para. A38A).

(d) Each of the components of internal control as they relate ~~relating to~~ making accounting

⁵ ISA 315 (Revised), paragraphs 11–(a)

estimates.⁶ (Ref: Para. A38B–A38P)

9. The auditor shall review the outcome or re-estimation of previous accounting estimates to the extent that doing so will assist in identifying and assessing the risks of material misstatement in the current period. ~~The nature and extent of the auditor's review shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. However, ~~the~~ the review is not intended to call into question, based on new information, ~~that was not available at the time, the~~ judgments made at the time the about previous accounting estimates that were appropriate based on the information available at the time made.~~ (Ref: Para. A38Q–A44)
- 9A. The auditor shall, ~~in the course of obtaining an understanding of the accounting estimates,~~ consider whether specialized skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement and related activities. (Ref: Para. A44A–A44E)

Identifying and Assessing the Risks of Material Misstatement

10. In applying ISA 315 (Revised), the auditor is required to identify and assess the risks of material misstatement, at the financial statement and assertion levels, and to determine~~including determining~~ whether any of the risks of material misstatement identified are, in the auditor's judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate, the auditor shall take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including: (Ref: Para. A44F–A44M)
- (a) Complexity in making the accounting estimate, including:
- (i) The extent to which the method used by management ~~necessarily~~ involves specialized skills or knowledge, including with respect to the use of a model; and ~~or~~ (Ref: Para. A44N–A44P)
- (ii) The difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data; ~~including internal data from sources outside the general and subsidiary ledgers and data from external sources.~~ (Ref: Para. A44Q–P)
- (b) The need for the use of judgment by management, ~~in making the accounting estimate and the potential for management bias,~~ including judgment with respect to methods, assumptions, and ~~sources of relevant and reliable data; or~~ and (Ref: Para. A44R–A44S)
- (c) Estimation uncertainty, including the ~~sensitivity of~~ extent to which the accounting estimate ~~to estimate is sensitive to the selection of different methods or to variations in the~~ assumptions use of particular data, and data assumptions used, and methods; (Ref: Para. A44T–A49B/A49C)

Responses to the Assessed Risks of Material Misstatement

- 11A. In responding to the assessed risks of material misstatement related to accounting estimates~~in accordance with paragraphs 13–13D~~, the auditor shall consider whether

⁶ ISA 315 (Revised), paragraphs 14–24

specialized skills or knowledge are required to design and perform audit procedures, or to evaluate audit-the results of those procedures. (Ref: Para. A44A–A44F)

13. In applying ISA 330, the auditor is required to design and perform further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. In doing so, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that relevant controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. With respect to accounting estimates: (Ref: Para. A57A–A57GH)
- (a) If the assessed risk of material misstatement is low, and-but not because that assessment does-not includes an expectation that relevant controls are operating effectively, the auditor shall consider whether a neverall—procedure(s) that addresses management's point estimate at an overall level would provide sufficient appropriate audit evidence regarding the assessed risk of material misstatement in the circumstances. (Ref: Para. A57H)
 - (b) If the assessed risk of material misstatement is low and that assessment includes an expectation that relevant controls are operating effectively, the auditor's further audit procedures shall include tests of controls to obtain audit evidence about the applicable—matters in paragraphs 13A–13C, when applicable. Such procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10. (Ref: Para. A57I)
 - (c) If the assessed risk of material misstatement is not low, the auditor's further audit procedures shall include procedures to obtain audit evidence about the applicable matters in paragraphs 13A–13C, when applicable. Such procedures (whether substantive procedures or tests of controls) shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needs to be. (Ref: Para. A57JK–A57LM)

Complexity

- 13A. In complying with paragraphs 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include complexity in making the accounting estimate, the auditor shall obtain [sufficient appropriate] audit evidence about the following matters when management's uses of a complex method (including using complex modelling), or about when management's method otherwise involves the use of specialized skills or knowledge the following matters below: (Ref: Para. A57NA59A–A59D7Q)
- ~~(a) —When the method necessarily involves specialized skills or knowledge, including with respect to a complex model: (Ref: Para. A57P–A59AA)~~
 - (ia) Whether the method and significant data and assumptions, are-is appropriate in the context of the applicable financial reporting framework;

- (#b) Whether significant data is relevant and reliable data (and other information used to develop assumptions) to which the accounting estimate is particularly sensitive is relevant and reliable.⁷
- ~~(iii) Whether management has appropriately understood or interpreted significant data, including with respect to contractual terms. (Ref: Para. A59E)~~
- ~~(b) When management uses a complex method, including a complex model,~~
- ~~(d) Whether the integrity of significant data and assumptions has been maintained in applying the method; and (Ref: Para. A59F)~~
- ~~(iie) Whether the calculations are mathematically have been accurately performed and are appropriately reflect the application of the method applied; Ref: Para A59B-A59H)~~

Judgment

- 13B. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include the need for the use of judgment by management ~~in making the accounting estimate~~, the auditor shall obtain ~~sufficient appropriate~~ audit evidence about the applicable following matters ~~below~~:
- (a) When the accounting estimate ~~is particularly sensitive to changes in~~ involves the use of data and assumptions significant data; or assumptions:
 - (i) Whether ~~the management's judgments regarding the selection of the methods and; the significant data and~~ assumptions and data are; (Ref: Para A59G)
 - a. Are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework; or
 - b. ~~(ii) Whether management's selection of methods, assumptions and data (including external information sources) are~~ Give rise to indicators of possible management bias; ~~(Ref: Para. A59I-A59J)~~
 - (ii) Whether management's judgments about changes from previous periods in the method or the significant data or assumptions, are appropriate (Ref: Para. A59HJA-A59LM);
 - (iii) Whether ~~management considered alternatives to the assumptions and whether the significant~~ assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities. (Ref: Para. A59K-A59M);
 - ~~(viii) Whether management's judgments in applying the requirements of the applicable financial reporting framework are appropriate;~~
 - ~~(iv) Whether management has appropriately understood or interpreted data, including with respect to contractual terms. (Ref: Para. A59N)~~

⁷ ISA 500, paragraph 7

~~(v) Whether management's judgments in applying the requirements of the applicable financial reporting framework are appropriate in the circumstances of the entity; (Ref: Para. A59O)~~

~~(vi) Whether changes in methods, assumptions and data sources from the prior period are appropriate (Ref: Para. A59P–A59R);~~

(b) When relevant to the appropriateness of the significant assumptions ~~to which the accounting estimate is particularly sensitive~~ or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and ~~its~~ has the ability to do so (Ref: Para. A59MS);

(c) When management's application of the method involves ~~uses a~~ complex modelling ~~(see also paragraph 13A(a))~~, whether judgments made the complex model has have been applied consistently and whether, when applicable: ~~(Ref: Para. A59T)~~

(i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;

(ii) Changes, if any, from the previous period's model are appropriate in the circumstances; and

(iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework. (Ref: Para A59N)

Estimation Uncertainty

13C. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor shall obtain ~~[sufficient appropriate]~~ audit evidence about the applicable following matters ~~below~~: ~~(Ref: Para. A59U)~~

(aa) Whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to: (Ref: Para. A59O)

(i) Understand and address the estimation uncertainty, and develop a point estimate that meets the measurement objective of the applicable financial reporting framework; and

(aii) Having regard to the extent to which the accounting estimate is particularly sensitive to the use of certain data, assumptions, and methods:

(a) Whether management's point estimate or range (or an element thereof) is reasonable; and ~~(Ref: Para. A59V–A59Z)~~

(b) Whether the disclosures in the financial statements that describe the estimation uncertainty are appropriate reasonable in the context of the applicable financial reporting framework (Ref: Para. A60A–A60B)

(b) When, in the auditor's judgment, management has not adequately appropriately addressed the effect of estimation uncertainty ~~(see paragraph 8(c)(iv))~~, based on the audit evidence obtained, the auditor shall, to the extent possible, develop an

auditor's point estimate or range, using appropriate methods, data and assumptions, to enable the auditor to evaluate the reasonableness of management's point estimate and the disclosures in the financial statements that describe the estimation uncertainty. management's point estimate. If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. The auditor shall evaluate the range of reasonable outcomes in the context of the requirements of the applicable financial reporting framework (Ref: Para A60C–A60GK)

(c) If, based on the audit evidence obtained, the auditor concludes that it is not appropriate to determine an auditor's point estimate, but that it is appropriate to develop an auditor's range, the auditor shall only include in that range amounts that: (Ref: Para A60L–A60M)

(i) Are supported by the audit evidence; and

(ii) The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.

Disclosures Related to Accounting Estimates

13D. The auditor shall obtain sufficient appropriate audit evidence to evaluate whether the accounting estimates have been appropriately disclosed in accordance with the requirements of the applicable financial reporting framework and: (Ref: Para. A120–A121A)

- (a) In the case of a fair presentation framework, shall evaluate whether it is necessary for management to provide disclosures beyond those specifically required by the framework to achieve the fair presentation of the financial statements as a whole, or
- (b) In the case of a compliance framework, shall evaluate whether the disclosures are appropriate for the financial statements not to be misleading.

Overall Evaluation Based on Audit Procedures Performed

Note – paragraphs 13E and 13F are shown with marked changes from the IAASB's January 31st Teleconference

13E. In applying ISA 330,⁸ to the accounting estimates for which the auditor's further audit procedures address the matters in paragraphs 13A–13C, the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A121B–A121D)

(a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified; and

~~(a)~~(b) Sufficient appropriate audit evidence has been obtained ~~about the accounting estimates, including; and~~ (Ref: Para AX1–AX5)

⁸ ISA 330, paragraphs 25 and 26

~~(b)(c) Whether management's decisions relating to the recognition, measurement, presentation and disclosure of the accounting estimates in the financial statements are in accordance with the applicable financial reporting framework and have been applied consistently applied; and~~

~~(c) In respect of the matters required to be addressed in accordance with paragraphs 13A–13C, as applicable.~~

~~In evaluating the above matters, the auditor shall consider all relevant audit evidence, whether corroborative or contradictory.~~

- 13F. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate whether the accounting estimates and related disclosures are either misstated, or are reasonable in the context of the applicable financial reporting framework, or are misstated. In making this evaluation, the auditor shall consider all relevant audit evidence obtained whether corroborative or contradictory. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit.⁹ (Ref: Para. ~~A1B–A1C, A121E–A121H~~X9)

Indicators of Possible Management Bias

21. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate ~~a possible bias on the part of the entity's management, that may represent a risk of material misstatement of the financial statements as a whole, including due to fraud~~ When indicators of possible bias are identified, If so, the auditor shall evaluate the implications for the audit ~~reevaluate the accounting estimates taken as a whole;~~ (Ref: Para. ~~A121Q–A121N~~5)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that they believe the methods and significant data and assumptions, used in making the accounting estimates and their related disclosures are ~~reasonable~~ appropriate. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, data, or assumptions, or data used. (Ref: Para. A126–A127)

⁹ ISA 330, paragraph 27

Communication with Those Charged With Governance or Management

22A. In applying ISA 260 (Revised)¹⁰ and ISA 265,¹¹ the auditor is required to communicate with those charged with governance or management about certain matters, including significant findings from the audit qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively, as required by ISA 260. In doing so, the auditor shall consider the matters, if any, to communicate related to the extent to which the accounting estimates and their related disclosures are affected by, or subject to, estimation uncertainty, complexity, use of judgment by management, or other relevant ~~factor~~factors. (Ref: Para. A127A–A127CB)

Documentation

23. The audit documentation shall include:

- (a) The basis for the auditor's ~~conclusions evaluation about of~~ the reasonableness of the accounting estimates and ~~their related~~ disclosures; and
- (b) Indicators of possible management bias, if any, and the auditor's evaluation thereof in forming their auditor's opinion on whether the financial statements as a whole are materially misstated. (Ref: Para. A128)

* * *

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1A. Examples of situations where accounting estimates may be required include:

- ~~Calculation of estimated credit losses.~~
- Inventory obsolescence.
- Warranty obligations.
- Depreciation method ~~or asset useful life~~.
- Outcome of long term contracts.
- Estimated cCosts arising from litigation settlements and judgments.
- Expected credit losses.
- Valuation of insurance contract liability~~liabilities~~.
- Valuation of complex financial instruments, including those that are not traded in an active market.
- Share-based payments.
- Assets or liabilities acquired in a business combination, including goodwill and intangible assets.

¹⁰ ISA 260 (Revised), Communication with Those Charged with Governance, paragraph 16(a)

¹¹ ISA 265, Communicating Deficiencies in Internal Control To Those Charged With Governance And Management paragraph 9

- Property or equipment held for disposal.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

Key Concepts (Ref: Para. 2, 13-F)

A1B. The auditor is required to obtain~~responsible for obtaining~~ sufficient ~~and~~ appropriate audit evidence about whether the accounting estimates recognized or disclosed, are reasonable. What is reasonable depends on the facts and circumstances in the context of the applicable financial reporting framework. ~~An accounting estimate may be reasonable when it is in accordance with the applicable financial reporting framework. For example, it may not be possible to measure reliably the expected proceeds from a lawsuit may and therefore should not be recognized as an asset or as income. However, the existence of the claim would be disclosed in the financial statements.~~

A1C. The following factors may be relevant to the auditor's evaluation of whether the accounting estimate and related disclosures are reasonable:¹²

- The accounting estimate and related disclosures meet the requirements of the applicable financial reporting framework;
- The accounting estimate takes into account appropriate information available at the time of issuance of the auditor's report; and
- In the context of the applicable financial reporting framework and in view of the nature of the estimate and the facts and circumstances of the entity:
 - The method, assumptions and data (including related judgments) are appropriate;
 - The accounting estimate and its data and assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities; and
 - The disclosures are appropriate, including disclosures regarding estimation uncertainty.

~~A1B. Estimation involves making judgments based on information available when the financial statements are prepared. For many accounting estimates, these include making assumptions about matters that are uncertain at the time of estimation. The difficulty of estimating a financial statement item is influenced by several factors but often relates to the complexity, judgment or estimation uncertainty involved in making the accounting estimate.~~

~~A1D. The difficulty of estimating a financial statement item is influenced by several factors but often relates to the complexity, judgment or estimation uncertainty involved in making the accounting estimate.~~ *Management Bias*

~~A10. Management bias can be difficult to detect at an account level. It may only be identified when considered in the aggregate of groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form~~

¹² See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(c).

~~of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.~~

Definitions

Accounting Estimate (Ref: Para. 7(a))

A11A. Accounting estimates are monetary amounts that may be classes of transactions or account balances recognized in the financial statements, but also include accounting estimates used in disclosures or used to make judgments about whether or not to recognize or disclose a monetary amount. ~~An accounting estimate is subject to estimation uncertainty.. Where this ISA addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.~~

Auditor's Point Estimate or Auditor's Range (Ref: Para. 7(b))

A11B. An auditor's point estimate or a range ~~The auditor may develop a point estimate or range may be developed~~ for anthe accounting estimate as a whole; a subset of the accounting estimate (for example, the expected the credit losses for a particular loan portfolio or the fair value of different types of financial instruments), or a component of an accounting estimate (for example, an amount to be used as a significant assumptions or data for an accounting estimate), or an item of data or an assumption (for example, an estimated useful life of an asset). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating an item of data or an assumption (for example, an estimated useful life of an asset).

Estimation Uncertainty (Ref: Para. 7(c))

A11C. ~~Estimation uncertainty is the result of certain conditions, including:~~

~~Measurement methods required or permitted by the applicable financial reporting framework~~

~~Lack of access to information outside of the entity that affects the measurement of the estimate;~~

~~Uncertainty about future events or conditions; and~~

~~Limitations in data and analytical techniques, such as simplifying complex matters in order to develop a model.~~

Estimation uncertainty is an inherent characteristic of accounting estimates ~~and~~. The measurement effect of estimation uncertainty can be reduced by using appropriate available information sources. However, limitations in the availability of relevant information and in the practicality of using available information (e.g., when the cost of obtaining it exceeds the benefit of using it), mean that estimation uncertainty cannot be reduced beyond a certain level (in other words, residual estimation uncertainty) cannot be reduced by the application of auditing procedures. The nature and implications of estimation uncertainty are discussed further in Appendix B.

Management Bias (Ref: Para. 7(e))

A11D. Financial reporting frameworks often call for neutrality, that is, freedom from bias. The inherent lack of imprecision in the measurement of a Accounting estimates ~~are imprecise,~~

~~however, and gives rise to the need for the use of judgment can be influenced by~~ management ~~judgment~~. Such judgment may ~~be influenced by~~ involve unintentional or intentional management bias (for example, as a result of motivation to achieve a desired ~~profit target or capital ratios~~ result). The susceptibility of an accounting estimate to management bias increases with the ~~extent to which there is a need for~~ judgment ~~involved~~ in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

Outcome of an Accounting Estimate (Ref: Para. 7(f))

A11E. Some ~~accounting~~ estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this ISA. For example, ~~a fair value measurement an accounting estimate may be is~~ based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or the liability transferred may differ from the ~~fair value~~ accounting estimate at the reporting date because, with the passage of time, the ~~market participants'~~ perceptions of value may change.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this ISA assist the auditor in obtaining an understanding of the nature ~~and type of the~~ accounting estimates ~~and related disclosures~~ that an entity may ~~be expected to have~~ include in its ~~financial statements and of the entity's internal control relevant to making its accounting estimates~~. ~~In relation to the entity's accounting estimates, t~~The auditor's primary consideration is whether the ~~ate~~ understanding, ~~that has been obtained~~ is sufficient to:

- Identify and assess the risks of material misstatement, ~~including determining whether, in the auditor's judgment, any of those risks are significant risks in relation to accounting estimates; and~~
- ~~Determine whether any of those risks are significant risks or low risks; and~~
- Plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework ~~assists the auditor in determining whether, for example~~

~~Prescribes certain conditions for the recognition, P7F¹³P or methods for the measurement, of accounting estimates.~~

~~Specifies certain conditions that permit or require measurement at a fair value, for example, by~~

¹³ ~~Most financial reporting frameworks require incorporation in the statement of financial position or statement of other comprehensive income of items that satisfy their criteria for recognition. Disclosure of accounting policies or adding notes to the financial statements does not rectify a failure to recognize such items, including accounting estimates.~~

~~referring to management's intentions to carry out certain courses of action with respect to an asset or liability.~~

- ~~• Specifies required or permitted disclosures.~~

~~Obtaining this understanding also~~ provides the auditor with a basis for discussion with management and those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also ~~also~~ may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate in the circumstances of the entity.¹⁴

- A14. For certain accounting estimates, Financial financial reporting frameworks may prescribe, or provide guidance on, for management on the basis for selecting management's determining point estimate, which may be where alternatives exist. Some financial reporting frameworks, for example, require that the point estimate selected be the alternative that reflects management's judgment of the most likely outcome.¹⁵ ~~Others may require, for example, or use of a discounted probability-weighted expected value. In some cases~~ Depending on the circumstances, it may be possible for the accounting estimate to be determined management may be able to make a point estimate directly, or it may only be possible to select a management point estimate. ~~In other cases, management may be able to make a reliable point estimate only only after considering alternative assumptions or the range of possible measurement outcomes from which it is able to determine a point estimate.~~
- A15. Financial reporting frameworks may specify criteria for, or guidance on, require the disclosure of information concerning the significant judgments, assumptions, or other sources of estimation uncertainty relating to assumptions to which the accounting estimates are particularly sensitive. Furthermore, where there is a high degree of estimation uncertainty, some financial reporting frameworks do not permit certain accounting estimates to be recognized in the financial statements, but certain disclosures may be required in the notes to the financial statements.

Obtaining an Understanding of Regulatory Factors (Ref: Para. 8(aA))

A15A. Obtaining an understanding of the relevant aspects of the regulatory framework (e.g., regulation established by banking and insurance regulators) may assists the auditor in determining whether, for example, the regulatory framework:

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of by the applicable financial reporting framework; or;
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements.

¹⁴ ISA 260 (Revised), paragraph 16(a)

¹⁵ Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

A15B. Obtaining such an understanding may also highlight requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting purposes, which may indicate potential risks of material misstatement. For example, the measurement basis for certain financial statement items, for regulatory capital maintenance purposes, may require earlier recognition of losses than the measurement basis, in accordance with the applicable financial reporting framework, for an accounting estimate relating to the item.

A15C. ISA 250 (Revised) includes requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates, including regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.¹⁶

Obtaining an Understanding of the ~~Nature of the~~ Accounting Estimates That the Auditor Expects to be included in the Financial Statements (Ref: Para. 8(~~ab~~AB))

A15D24B. Obtaining an Understanding of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements assists the auditor in understanding the measurement basis and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management has made the accounting estimates.

The auditor may obtain an understanding of the ~~nature of the~~ accounting estimates that the auditor expects to be included in the financial statements through the auditor's:

- Understanding of the nature of the entity, including the nature of the assets and liabilities and other financial statement items that it would be expected to have, given the nature of its operations, ownership and governance structures and investments, the way it is structured and financed, its objectives and strategies and related business risks;
- ~~Understanding of the industry in which the entity operates;~~
- Understanding of the applicable financial reporting framework, and other relevant legal, regulatory and other external factors;
- Past knowledge and experience, including that obtained through other audits ~~and education~~; and
- Previous experience with the entity.¹⁷

A15E24A. Developing an expectation ~~Obtaining an understanding~~ of the nature of the accounting estimates and related disclosures may also assist the auditor in understanding whether the accounting estimates are complex to make, require significant judgment by management, or have high estimation uncertainty.

Obtaining an Understanding of How Management Identifies the Need for the Accounting Estimates (Ref: Para. 8(b))

A16. The preparation of the financial statements requires management to determine whether

¹⁶ ISA 250 (Revised), Consideration of Laws and Regulations in an Audit of Financial Statements, paragraphs 12 and A7

¹⁷ ISA 315 (Revised), paragraph 9

a transaction, event or condition gives rise to the need to make ~~an~~^{the} accounting estimates, and that all necessary accounting estimates have been recognized, measured, ~~presented~~, and disclosed in the financial statements, in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in ~~previous~~^{or} periods.

~~In such cases, t~~^{The} auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. ~~In other cases, where~~^{Management may periodically review the circumstances that give rise to the need for accounting estimates and for re-estimating them as necessary. Further, management may have established a risk assessment process in this area which may involve management's process is more structured, for example, when management has a formal risk management or similar function. In such circumstances, the auditor's may perform risk assessment procedures may be directed at understanding such a review or risk assessment processes directed at the methods and practices followed by management for periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating the accounting estimates as necessary. How management addresses t}^{The completeness of accounting estimates, particularly estimates related to liabilities, is often an important consideration of the auditor, particularly accounting estimates relating to liabilities.}

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained during the course of the audit, assists^s the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for ~~an~~^{accounting estimates}.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give

rise to the need for accounting estimates that management failed to identify. ISA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.¹⁸

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often more limited and their transactions are often subject to less complexity. Further, often a single person, for example the owner-manager, identifies the need to make the accounting estimates and the auditor's may focus inquiries may be focused accordingly.

~~For example, in order to make certain accounting estimates, management may use complex models, or the accounting estimates may be based on data that is not subject to the same level of control as data used to prepare financial statements. The accounting estimates may also involve a long forecast period, like some future cash flow predictions, and may therefore be susceptible to estimation uncertainty.~~ Obtaining an Understanding of How Management Makes Accounting Estimates (Ref: Para. 8(c))

A22. The preparation of the financial statements also requires management to establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying ~~or developing~~ relevant data and assumptions that are used in making ~~the~~ accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

- The types of accounts or classes of transactions to which the accounting estimate relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognized measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

¹⁸ ISA 315 (Revised), paragraph 16

Methods ~~of Measurement, Including the Use of Models~~(Ref: Para. 8(c)(i))

A23A. A method is a measurement technique used by management to apply the measurement basis in the financial reporting framework. In some cases, the applicable financial reporting framework may prescribe the method to be used for making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method or the required measurement basis prescribes, or allows, the use of alternative methods.

A23B. For example, one recognized method used to make accounting estimates relating to share based payment transactions is to determine a theoretical option call price using the Black Scholes option pricing formula. This method may be applied by modelling the data and assumptions of that formula based on the terms of the transaction and market conditions relevant to the underlying share.

A23C. A model is a tool used to make the accounting estimate that applies assumptions and data, ~~based on and~~ a set of relationships between them as specified by the method ~~and a complex model is a model that exhibits a significant degree of complexity in its design or operation. For example, one of the methods to value share-based payments is by determining a theoretical call price. The Black Scholes option model can be used to apply this method. A model may also be used to develop an assumption.~~

A23D. A model is complex when:

- The method it applies requires more specialized skills or knowledge;
- It is more difficult to obtain relevant and reliable data needed for use in the model;
- It is difficult to maintain the integrity of that data:-
- It exhibits a significant degree of complexity in its design or operation, which may, for example, involve more extensive use of information technology or large volumes of data; or
- It uses multiple data sources or assumptions with complex-interrelationships.

A24. In some cases, the applicable financial reporting framework may prescribe the method of measurement for an accounting estimate, which may include, for example, use of a particular model that is to be used in measuring a fair value estimate. In many cases, however, the applicable financial reporting framework does not prescribe the method of measurement, or may specify alternative methods for measurement.

A25. When the applicable financial reporting framework does not prescribe a particular method to be used in the circumstances, matters that the auditor may consider in obtaining an understanding of the method, and where applicable the model, used to make accounting estimates include, for example:

- How management considered the nature of the asset or liability being estimated when selecting a particular method.
- Whether the entity operates in a particular business, industry or environment in which there are methods commonly used to make the particular type of accounting estimate.

A25A. If the entity uses a model, whether management's own model or an external model, Management may design and implement specific controls around models used for

making ~~an~~ accounting estimates, whether management's own model or an external model~~management may put into place specific controls around such models, including any discrete parts of such models that are relevant to the audit. Controls that address complexity around models are more likely to be~~This is especially relevant to the audit when the model to make the accounting estimate used ~~is considered to be~~ complex, such as, an expected credit loss model or a model used for the valuation of insurance contracts liabilities. ~~The complexity of a model depends on factors such as a model that has many discrete parts, the complexity of the formulas and interrelationships within the model that may require specific expertise. Depending on the nature of the model and the accounting estimate,~~ Factors that may be appropriate for the auditor to considered in obtaining an understanding of the model used to make the accounting estimate and of the related control activities ~~thereon~~, include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model process may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity;
 - The accuracy and completeness and consistency of the model's data and assumptions used in the model; and
 - ~~The consistency of the data and assumptions; and~~
 - Whether the appropriate data is used in the model and appropriate assumptions have been made;
- How t~~The~~ model is appropriately changed or adjusted on a timely basis for changes in ~~(market)~~ or other conditions and whether there are appropriate change control policies over the model;
- ~~The extent the model uses relevant observable data and assumptions and unobservable data and assumptions;~~
- Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether (such as may be adjustments are appropriate under the circumstances and needed to ensure that the model's output complies consistent with the requirements of the applicable financial reporting framework); and
- Whether the model is adequately documented, including its~~the model's~~ intended applications, and limitations, and its key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its~~the~~ output of the model.

A26. There may be a greater susceptibility to risks of material misstatement relating to the use of models that are not low risk, for example, in cases when management has internally developed a model internally but has relatively little experience in doing so, or uses a model that applies a method that is not established or to be used in making the accounting estimate or is departing from a method commonly used in a particular industry

or environment.

Assumptions Ref: Para. 8(c)(ii))

A26A. Assumptions are integral components of accounting estimates and may include matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of possible alternatives for use in applying a method to make an accounting estimate.

~~A26F. The applicable financial reporting framework sometimes provides criteria or guidance to be used in the selection of an assumption. For example, the applicable financial reporting framework may prescribe that a discount rate be used for a certain accounting estimate. Because different discount rates may be selected based on judgment, the discount rate is an assumption used in the accounting estimate.~~

~~A26G. It may not be clear whether a particular item represents data or an assumption. Data for one model could be considered an assumption for another model, or two auditors may come to different professional judgment as to whether an item is data or an assumption. Regardless, the auditor may need to consider what could go wrong with the data or assumption.~~

A31. Matters that the auditor may consider in obtaining an understanding of the assumptions used ~~in to make~~making the accounting estimates include, for example:

- The nature of the assumptions used, the alternatives considered and the basis for management's selection. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.
- How management assesses whether the assumptions are relevant and complete ~~(that is, that all relevant variables have been taken into account).~~
- When applicable, how management determines that the assumptions ~~used across accounting estimates~~ are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities.
- How the assumptions are consistent with other ~~relate to~~ matters:
 - W ~~within~~ the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life), and whether how they are consistent with ~~conform to~~ the entity's business plans and the external environment; and, or relate to matters that are
 - O ~~outside the control of management~~ its control (for example, assumptions about interest rates, interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- ~~The nature and extent of m~~Management's documentation supporting the assumptions.
- The disclosures of assumptions required by the applicable financial reporting framework.
- How management identifies significant assumptions.

Assumptions may be made or identified by a management's expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A35. With respect to fair value accounting estimates, assumptions vary in terms of their sources of the data and the bases for the judgments to support them, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity.
- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

~~A36. The extent of subjectivity, such as whether an assumption is observable, influences the degree of estimation uncertainty and thereby the auditor's assessment of the risks of material misstatement for a particular accounting estimate.~~

Significant data and assumptions

~~A35A107.~~ Data and An assumptions used in making an accounting estimate may be deemed to be referred to as significant data or significant assumptions in this ISA if a reasonable variation in the data or assumption would materially affect the measurement of the accounting estimate.

~~A38A. Accounting estimates may be particularly sensitive to changes in certain data and assumptions.~~ For example, an accounting estimate may be determined applying a method based on a model that uses several data sets and several assumptions, one or more of which particularly influences the measurement outcome of the accounting estimates because the range of reasonable assumptions may be large or the model may be sensitive to a specific data or assumption because of the underlying formulas. ~~The auditor may consider obtaining an understanding of how management identifies relevant data and assumptions to which the accounting estimate is particularly sensitive.~~

Inactive or illiquid markets

~~A35B~~A59R. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. Estimation uncertainty increases and valuation is more complex when the markets in which financial instruments or their component parts are traded become inactive. Valuation techniques selected in times when market information was available may not provide appropriate valuations in times of stress. However, even where markets are inactive, prices achieved may still provide relevant evidence about fair value. In these circumstances, valuations may be developed based on more unobservable inputs, requiring more judgment by management. When markets are inactive, prices quoted may not represent prices at which market participants would trade or may represent forced transactions (such as when disposal of an asset is necessary to meet regulatory or legal requirements).

~~A35C~~59RA. Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial

~~instruments that have previously been valued using market prices may need to be valued using a model; or, where they have previously been valued using a model, the model may need to change. Reacting to changes in market conditions may be difficult if management does not possess the specialized skills or knowledge necessary to develop an appropriate model on a timely basis, or to select the valuation technique that may be most appropriate in the circumstances. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.~~

A35DA. When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;
- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate, in such circumstances;
- The resources to calculate the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data from particular external information sources may vary in such circumstances.

Data ~~of Measurement, Including the Use of Models~~(Ref: Para. 8(c)(ii)A)

A35E. Data comprises factual data, which can be observed directly, and derived data, which is data obtained through applying analytical or interpretive techniques to factual data. The analytical or interpretive techniques to be used in deriving data have a well-established theoretical basis and do not involve the application of ~~are subject to judgment, as there is, when defined properly, no choice in how the technique is applied. For example, the weighted average of a series of values requires a calculation, but there is only one way to calculate the weighted average.~~ Examples of data include:

- Prices agreed in market transactions;
- risk management data, Operating times or quantities of output from a production machinedata on usage of an asset historical prices; or

- Historical prices or other terms data included in contracts (for example, ~~for a loan agreement the data~~ may include ~~the~~ contracted interest rate, ~~a~~ payment schedule, and term of the ~~loan contract~~); ~~or~~;
- Forward looking data such as economic or earnings forecasts made publicly, or a future payment schedule in a loan agreement.

A35F. Data can come from a wide range of sources. For example, data can be:

- ~~Be generated internally within the organization~~ or externally;
- ~~Be historic or forward looking;~~
- ~~Obtained~~ ~~Come~~ from ~~systems inside a system that is either within~~ or outside the general or subsidiary ledgers; ~~and~~
- Observable in ~~Come from contracts; and~~
- Observable ~~—or—in legislative or regulatory pronouncements~~ ~~Be based on a contractual or legal terms.~~

Understanding the source of the data used to make the accounting estimates may help the auditor in understanding the risks with respect to the relevance and reliability of the data. ~~used to make the accounting estimate. Selecting data to use in an accounting estimate may require management's judgment about the relevance and reliability of the data, including the reputation of the source of the data.~~

A35G. Matters that the auditor may consider in obtaining an understanding of the data on which ~~the an~~ accounting estimates s are is based include:

- The nature of the data.
- ~~The source of the data, including whether the data has been obtained from outside the general and subsidiary ledgers or generated by external data sources~~ How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data;
- The consistency of the data used with data used in previous periods.
- ~~The~~ complexity ~~use of the~~ information technology ~~systems and the complexity resulting from the need for those systems used to obtain and process the data, including when this involves~~ to handle large volumes of data.
- ~~How, including how transactions or the data is obtained, are transmitted and, processed and how its integrity is or maintained electronically.~~

A35H. When making an accounting estimate ~~requires large volumes of data, management may involve large volumes of data or otherwise involves complex processing, management may make the have~~ extensive use of information technology. In such cases systems in place, it may be necessary for the auditor to understand and test information technology general controls and relevant application controls. and general information technology and application ~~Such controls may be necessary. Such controls address risks related to are directed towards;~~

- The complete and accurate extraction of data from the entity's records or ~~obtained from appropriate external information sources~~ third parties; and

- The complete and accurate flow of data through the entity's information systems and the appropriateness of~~that~~ any modification to the data used in making the accounting estimates~~s~~, such as the translation of data into a different currency,~~is~~ appropriate. Controls to maintain the integrity and security of the data are important.

Management's Application of Specialized Skills or Knowledge, Including the Use of Management's Experts (Ref: Para. 8(c)(iii))

A35I. Management may have, or the entity may employ individuals with, the skills and knowledge~~experience and competence~~ necessary to make the accounting estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.
- The complex technical~~nature~~ of the models required to apply~~meet~~ the relevant requirements of the applicable financial reporting framework, as may be the case in certain measurements, such as level 3 -at-fair values.
- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

A failure by management to apply the required specialized skills or knowledge, including engaging~~ing~~ an expert when management does not otherwise have access to ~~such an~~ individual with ~~the necessary experience and competence~~such skills and knowledge, increases ~~the~~ control risk.

Considerations specific to smaller entities

A35J. In smaller entities, the circumstances requiring ~~an~~ accounting estimates~~s~~ often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner-manager in determining the need to use an expert.

Risk of Management Bias (Ref: Para. 8(c)(iB))

A35K. Matters that the auditor may consider in obtaining an understanding of how management addresses the risk of management bias in making accounting estimates includes whether, and if so how management:

- Identifies and pays particular attention to accounting estimates that involve greater levels of subjectivity in related judgments.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.

- Monitors changes in the methods, or in significant sources of data and significant assumptions, used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

Estimation Uncertainty (Ref: Para. 8(c)(iv))

A38. Matters that may be appropriate for the auditor ~~to may~~ consider in obtaining an understanding of whether and, if so, how management has addressed estimation uncertainty include, for example:

- Whether and, if so, how management has identified alternative methods, ~~sources of significant data, or significant assumptions,~~ or sources of significant data that are appropriate-relevant in the context of the applicable financial reporting framework.
- Whether and, if so, how management has considered alternative ~~assumptions or~~ outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the data or assumptions on ~~an the~~ accounting estimates.
- How management determines its point estimate~~the accounting estimate~~ when analysis indicates a number of possible outcome scenarios.
- Whether management monitors the outcome of accounting estimates made in ~~the previous~~prior periods, and ~~how whether~~ management has appropriately responded to the result~~outcome~~ of that monitoring ~~procedure~~.

Changes in Methods, Assumptions or Data Used in ~~for~~ Making Accounting Estimates (Ref: Para. 8(c)(vi))

A38A. In evaluating how management makes the accounting estimates, the auditor is required to understand ~~whether there has been or ought to have been a change from the prior period in the methods for~~ the extent to which management has identified and addressed the need for change in the methods, assumptions or data used in making the accounting estimates. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment. ~~For example, if management changes the basis of making an accounting estimate from a mark-to-market approach to using a model, the auditor may challenge whether management's assumptions about the marketplace are reasonable in light of economic circumstances. It is also important that management can demonstrate, when no change has been made, -that the continued use of the previous~~ methods, assumptions and data is appropriate in view of the current environment or circumstances. For example, whether management's assumptions about marketplace transactions or price quotes reflect fair value when there is reduced market activity.

Components of Internal Control Relating To Accounting Estimates (Ref: Para. 8(d))

A38B. Paragraphs 14–24 of ISA 315 (Revised) describes the components of internal control and provide useful information for the auditor in considering the components of internal

control as they relate to making accounting estimates.

A38C. Some entities may have a wide range of accounting estimates, some of which may be significantly affected by, or subject to, complexity, the need for use of judgment by management, and estimation uncertainty. In such circumstances, there may be an increased need for the application of specialized skills or knowledge, and management may make extensive use of information technology in making the estimates. In such cases, it likely will be more important for the auditor to understand of the design and implementation, and test the operating effectiveness, of related controls. It is likely to be less important for entities that may not have many, or any, estimates that exhibit such characteristics.

The Control Environment Relevant To Making Accounting Estimates

~~A38D. The nature and extent of the entity's internal control will vary depending on the size of the entity and the nature of its activities. For example, in entities that have accounting estimates that require extensive reliance on information technology and use of large volumes of data, management may enforce a more strict control environment than it does elsewhere within the entity. When management's knowledge and experience about certain complex accounting estimates is limited, the auditor may need to obtain an understanding of the control environment applicable to those responsible for making these complex accounting estimates. The auditor's understanding of the control environment relevant to making accounting estimates includes consideration of the influence that the elements of the control environment would be expected to have on the risks of material misstatement.¹⁹ This may include, for example, whether:~~

- ~~• Management, with the oversight of those charged with governance, has created and maintained a culture of transparency and proper honesty and ethical behavior, as it relates to making the accounting estimates; and~~
- ~~• The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, insofar as they relate to the accounting estimates, and whether those other components are not undermined by deficiencies in the control environment.~~

~~A38E. Management and, where applicable, those charged with governance are responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. The effectiveness of the design of the control environment in relation to participation by those charged with governance is influenced by the matters described in paragraph A80 in ISA 315 (Revised).~~

~~A38CE. In some industries, such as the banking or insurance industry, the term governance may be used to describe the control environment as described in ISA 315 (Revised).²⁰~~

Oversight by those charged with governance

~~A38F. Management and, where applicable, those charged with governance are responsible for designing and implementing a system of internal control to enable the preparation of~~

¹⁹ [ISA 315 \(Revised\), paragraph A77](#)

²⁰ [ISA 315 \(Revised\) paragraph A76](#)

financial statements in accordance with the applicable financial reporting framework. The effectiveness of the design of the control environment in relation to participation by those charged with governance is influenced by the matters described in paragraph A80 in ISA 315 (Revised).

A38G. ~~Those charged with governance oversee the control environment set by management.~~
How effective those charged with governance are in overseeing the control environment set by management~~this role~~, with respect to accounting estimates, may be influenced by such matters as the extent to which they:

- Have the skills or knowledge to ~~uWhether they understand~~ the characteristics~~risks~~ of using a particular method or model to make ~~an~~ accounting estimates, ~~or have sufficient skills and experience to assess~~ the risks related to the accounting estimate ~~of~~, for example, risks related to the method or information technology used in making the accounting estimates~~s~~;
 - ~~The extent to which those charged with governance~~ Have the ~~experiences~~skills and knowledge to understand whether management made the accounting estimates s in accordance with the applicable financial reporting framework; or
 - Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to challenge management when ~~re those actions appear to be inadequate or inappropriate.~~
- ~~Their independence from management and their ability to evaluate the actions of management.~~

A38H. Depending on the nature of the~~an~~ accounting estimates~~s~~, the auditor may consider obtaining an understanding of the oversight ~~of the accounting estimate by those charged with governance over matters, including any models used in its development, by those charged with governance, including~~ such as:

- Management's process for making the accounting estimates, including the use of models~~The process for oversight of accounting estimates by management and, if applicable, those charged with governance, whose design takes into account the complexity, judgment and estimation uncertainty related to the accounting estimates.~~
- The monitoring activities ~~as part of the system of internal control~~, undertaken by management ~~and, if applicable, those charged with governance~~. This may include appropriate~~adequate~~ supervision and review of the accounting estimates ~~within the entity~~ designed to detect and correct any deficiencies in the operating effectiveness of controls over the accounting estimates ~~and its measurement~~.

A38I. The oversight by those charged with governance may particularly be important for accounting estimates that:

- Require significant judgment by management, for example in the selection of the method, significant assumptions or significant data;
- Have ~~a~~ high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information technology, large volumes of data or the use of multiple data sources or

assumptions with complex-interrelationships;

- Have Had, or ought to have had, a change in the method, assumptions or model or data compared to previous or periods year; or
- Involve Are significant data and assumptions particularly sensitive to changes in certain data and assumptions.

The Entity's Risk Assessment Process

~~A38I. In relation to accounting estimates, an entity's risk assessment process establishes how management identifies business risks relevant to financial reporting objectives, including how these objectives related to making the accounting estimates, including how management estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon actions to manage them. The types and levels of risks an entity faces are often directly related to the types of accounting estimates the entity makes and often the complexity of the business model.~~

~~A38J. If the entity has a risk assessment process, the auditor needs to obtain an understanding of the process and its results in relation to the entity's accounting estimates, including how management determines the risks to be managed arising from changes in~~With respect to making accounting estimates, the objective of the risk assessment processes is to ~~assist~~ management in:

- ~~Understanding~~ The requirements of the applicable financial reporting framework related to the accounting estimates;
- ~~The availability or nature of~~ Selecting data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used ~~relevant and reliable~~;
- ~~The entity's~~ Maintaining appropriate information systems or IT environment; and
- ~~Having procedures in place to reduce or change risk exposure if necessary and for managing reputational risk; and~~
- ~~Making accounting estimates with appropriate supervision and review~~ Key personnel.

The Entity's Information Systems

~~A38K. The Entity's information system consists of the procedures and records established to initiate, record, process and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities and equity.²⁴ Difficulties can arise for accounting estimates that require large volumes of data, in particular if the data comes from multiple systems that are not adequately integrated or have manual interfaces without appropriate controls.~~

~~A38L. The sophistication of the information system may depend on the nature of the accounting estimates and the entity's business processes. For example, the use of an expected credit loss model, may require a large volume of data and therefore may require sophisticated information systems. Specific risks that can arise with respect to accounting~~

²⁴ ISA 315 (Revised), paragraph 18

~~estimates that require a large volume of data or require the extensive use of information technology include~~

A38K. With respect to the entity's information system relevant to making accounting estimates, it may be appropriate for the auditor to~~may~~ obtain an understanding as to whether:

- ~~The~~ Information systems ~~have not having~~ the capability and are or not being appropriately configured to process large volumes of data. ~~This may result in an increased number of manual transactions, which may further increase the risk of inaccurate or incomplete data;~~
- ~~When d~~ Diverse systems are required to process ~~more~~ complex transactions, and the need for regular reconciliations between the ~~systems~~ are made, in particular when the systems ~~do are~~ not have automated interfaces ~~ed~~ or may be subject to manual intervention;
- ~~A lack of review of~~ Systems exception logs, to validate the entries generated by the systems;
- ~~Failure to evaluate t~~ The design and calibration of complex models is periodically evaluated initially and on a periodic basis;
- Management ~~has not having~~ established a library of models, with controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models; ~~and~~
- ~~When using external~~ information sources, management considered and appropriately not considering the addresses the risks related to appropriately recording, processing or recording, or accounting for the data, recognizing as management's ~~is still~~ responsibility ~~le~~ for appropriately reconciling and challenging the data from those sources; and
- There are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over related journal entries.

A38L. Information systems relevant to financial reporting ~~are serve as~~ are an important source of ~~data~~ for the quantitative and qualitative disclosures in the financial statements. ~~However, This may include a system developed and maintained by the entity ies may also develop and maintain systems for primarily for~~ internal reporting, ~~and to but which also captures, processes and generates data that may be included in qualitative disclosures relating to accounting estimates, for example regarding risks and uncertainties or sensitivity analyses.~~

The Control Activities

A38M. Matters that t ~~The auditor~~ needs to may consider in obtaining an understanding of the control activities relevant to the audit as they relate to making the accounting estimates and t–he auditor's consideration of such control activities may be more important when the accounting estimates are significantly subject to, or affected by, complexity, the use of judgment by management, or estimation uncertainty. This may include ~~include, for example, the experience and competence of those who make the accounting estimates, and control~~ activities related to:

- How management determines the relevance and reliability of the data used to develop the accounting estimates, including when management uses an external information~~data~~ source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. ~~E~~(for example, in the case of a large financial institution, relevant segregation of duties may includeconsist of an independent function responsible for estimation and validation of fair value pricing of the entity's proprietary financial products staffed by individuals whose remuneration is not tied to such products).
- The control activities included in paragraph A25A.

~~A38O. Other controls may be relevant to making the accounting estimates depending on the circumstances. For example, if the entity uses specific models for making accounting estimates, management may put into place specific policies and procedures around such models. Relevant controls may include, for example, those established over:~~

- ~~• The design and development, or selection, of a particular model for a particular purpose.~~
- ~~• The completeness, relevance and accuracy of the model.~~
- ~~• The use of adjustments over the outcome of the model.~~
- ~~• The changes made to the model, for example because of changes in (market) conditions.~~
- ~~• The maintenance and periodic validation of the integrity of the model.~~

The Entity's Activities to Monitor Controls over How the Accounting Estimates Are Made

~~A38N. For entities with an internal audit function, its work may be relevant to the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates. Where an entity has an internal audit function, internal audit may perform work that enables management and those charged with governance to review and evaluate the entity's controls relating to significant accounting estimates. The internal audit function may assist management in identifying the risks of material misstatement due to fraud or error. The extent to which the internal audit function has the experience and knowledge to cover, and has in fact covered, the entity's activities with respect to accounting estimates that are complex to make, as well as the competence and objectivity of the internal audit function, is a relevant consideration in the auditor's determination of whether the internal audit function is likely to be relevant to the auditor's assessment of the risks of material misstatement.~~

~~A38O. Areas where the work of the internal audit function may be particularly relevant~~ include understanding~~are:~~

- ~~• Documenting an overview of~~ Ithe nature and extent of management's use of

accounting estimates;

- The design and implementation~~Evaluating the operating effectiveness~~ of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
- Evaluating~~The~~ systems that generate the data on which the accounting estimates are~~is~~ based; and
- How~~Evaluating whether~~ new risks relating to accounting estimates are identified, assessed and managed.

Considerations Specific to Smaller Entities

A38P. In smaller entities, accounting estimates may often be generated outside the general ledger, controls over their development may be limited, and an owner-manager may have significant influence over the determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering management bias. ISA 315 (Revised)²² includes specific considerations to smaller entities that the auditor might find helpful in obtaining an understanding of the components of internal control that are relevant to making ~~the~~ accounting estimates.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 9)

A38Q. A retrospective review may be useful to the auditor in identifying and assessing the risks of material misstatement, specifically in circumstances when previous accounting estimates h

Have an outcome through transfer or realization of the asset or liability, ~~or~~ or a

Are re-estimated for the purpose of the current period. In certain circumstances, a retrospective review may not assist the auditor in identifying and assessing the risks of material misstatement. For example, for many fair value accounting estimates, there is no observable outcome as the fair value is based on a hypothetical transaction to exchange an item at the reporting date.

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the previous period's financial statements. By performing risk assessment procedures to identify and understand the reasons for such ~~For some accounting estimates with high estimation uncertainty the difference may be significant because of the nature of the accounting estimate. By performing risk assessment procedures to identify and understand the reasons for such differences~~ differences, the auditor may obtain:

- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain insight about ~~determine~~ the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of previous accounting estimates.

²² ISA 315 (Revised) paragraphs A52, A56, A57, A88, A93, A95, A101, A102 and A108

- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
- Information regarding the complexity and estimation uncertainty pertaining to the accounting estimates.
- ~~A40. The review of previous accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase information regarding the susceptibility of accounting estimates to, or indicate the presence that may be an indicator of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.~~

A39A~~T~~. A retrospective review may be performed over accounting estimates made for prior period financial statements but also for accounting estimates made ~~in the current period,~~ over several periods or a shorter period (such as half-yearly or quarterly). ~~For example, for certain accounting estimates, individually small changes to the assumptions that are not significant year-over-year become significant when aggregated over several years.~~ When entities make accounting estimates that are realized within a shorter timescale than full financial reporting periods, considering the outcomes of such accounting estimates may also provide important information about management's current effectiveness in making accounting estimates ~~competence~~ and other factors relevant to making estimates. Considering outcomes of accounting estimates that are realized between the end of the financial reporting period and the end ~~start~~ of the audit may be useful for similar reasons.

A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is also required by ISA 240²³. ~~That review is conducted as part of the requirement for the auditor to design and perform procedures to review accounting estimates for biases that could represent a risk of material misstatement due to fraud, in response to the risks of management override of controls always required by ISA 240.~~²⁴ As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this ISA may be carried out in conjunction with the review required by ISA 240—, when the auditor determines that performing a retrospective review will assist in identifying or assessing the risk of material misstatement.

A42. The auditor may determine ~~judge~~ that a more detailed review is required for those accounting estimates that ~~were identified during previous period audits as having high estimation uncertainty or as complex, or for those accounting estimates that have changed significantly from the previous period, or for those accounting estimates for which the assessed risk of material misstatement in the previous period audit was not low or was low and that assessment includes an expectation that relevant controls were operating effectively.~~ As part of the detailed review, the auditor may ~~perform a retrospective review over the assumptions for which small changes are likely to cause significant changes in the accounting estimate. For accounting estimates that arise from the recording of routine and recurring transactions, the auditor may judge that the~~

²³—ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

²⁴ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

~~application of analytical procedures as risk assessment procedures is sufficient for purposes of the review. pay particular attention, where possible, to the effect of significant assumptions used in making the previous estimates.~~

- A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date more variation may exist between the fair value amount recognized in the previous period's financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of previous period's fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.
- A44. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Specialized Skills or Knowledge (Ref: Para. 9A, 11A)

A44A. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.²⁵ ~~In some cases, the auditor may conclude that specialized skills or knowledge are required in relation to specific areas of accounting or auditing. This may include, as necessary, the involvement of those with specialized skills or knowledge.~~ In addition, ISA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts ~~who are not part of the engagement team~~, collectively have the appropriate competence and capabilities to perform the audit engagement.²⁶ During the course of the audit, the auditor may identify ~~at the~~ need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A44B. Matters that may affect the auditor's consideration of whether specialized skills or knowledge is required include, for example:

²⁵ ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

²⁶ ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

- The nature of the accounting estimates s for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance liabilities).
- The degree of estimation uncertainty.
- The cComplexity of the method or model used~~calculations or specialized models are involved, for example, when estimating fair values when there is no observable market.~~
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are is inconsistent ciest in how accounting estimates are made or developing.
- The procedures the auditor intends to undertake in responding to assessed risks.
- The need for judgment to be made about matters not specified by the financial reporting framework.
- The degree of judgment needed to select data and assumptions~~needed.~~
- The extent of the entity's use of information technology in information-making~~accounting estimates technology used in making the accounting estimate.~~

A44C. Many ~~For the majority of~~ accounting estimates do not require, ~~even when there is estimation uncertainty, it is unlikely that the application of~~ specialized skills or knowledge will be required. For example, for most audits it is unlikely that specialized skills or knowledge would be necessary for an auditor to evaluate a bonus accrual~~warranty provision.~~

~~A44DE. Further, in some cases, the auditor may conclude that it is necessary to obtain specialized skills or knowledge related to specific areas of accounting or auditing. However, for An example of such a case may be the allowance for expected credit losses offer an internationally active banking institution or the insurance contract liability for an life-insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge. Individuals with such skills or knowledge may be employed by the auditor's firm or engaged from an external organization outside of the auditor's firm. Where such individuals perform audit procedures on the engagement, they are part of the engagement team and, accordingly, they are subject to the requirements in ISA 220.~~

A44D. The auditor may not possess the specialized skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to use~~obtain it from~~ an auditor's expert. ISA 620²⁷ establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A44E. Depending on the auditor's understanding and experience of working with the auditor's expert or ~~those~~ other individuals with specialized skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable

²⁷ ISA 620, *Using the Work of an Auditor's Expert*

financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 10)

A44F. Obtaining an understanding of the entity and its environment, including the entity's internal control, as required by paragraph 8, assists the auditor in identifying areas of the financial statements that may be subject to potential misstatement and relevant risk factors that may give rise to potential risks of material misstatement related to accounting estimates.

A44G. Paragraph 10 requires the auditor, in assessing the risks of material misstatement, to take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including complexity, ~~or the use of judgment by management, in making the estimate, and estimation uncertainty. The sources behind the factors that give rise to the risk of material misstatement may be interrelated. For example, the financial reporting framework may be an inherent source of estimation uncertainty (as it may require an assumption when information is unavailable to make a more precise estimate); complexity (as it may require the use of a complex method) and judgment (as it may require management to choose a method to make the accounting estimate).~~

~~A44K~~A44H. For some accounting estimates, the auditor's assessment of the risk of material misstatement ~~may will be~~ low ~~but not because that assessment includes an expectation and the assessment does not include an expectation that relevant controls are operating effectively (in other words, the assessed risk of material misstatement is primarily influenced by lower inherent risk).~~ Examples may include:

- ~~• An allowance for doubtful accounts in a smaller, less complex entity.~~
- Depreciation calculations for an entity using a single depreciation method for property and equipment and a relatively low level of additions or disposals.
- ~~• Accounting estimates based on data that is readily available, such as published interest rate or foreign exchange rate data or exchange-traded prices of securities that are listed and actively traded on a recognized exchange, and few or no assumptions. An example of such an accounting estimate is the translation of a cash balance that is held in a currency other than the reporting currency.~~
- ~~• A bonus accrual for management which is based on the performance indicators that are clearly identified.~~

A44I. For some accounting estimates, the extent ~~to which they are subject to or affected by~~ complexity, judgment or estimation uncertainty may be such that the assessed risk of material misstatement ~~is not low, or is low but only because it includes an expectation that relevant controls are operating effectively is not low. Examples may include, for example:~~

- Accounting estimates relating to the outcome of litigation.
- Accounting estimates for financial instruments not publicly traded.
- Accounting estimates for which a ~~complex, highly specialized entity-developed~~ model is used or for which there are assumptions or data that cannot be observed ~~directly~~ in the marketplace ~~(level 3 fair values).~~

- Accounting estimates that collate, weight and integrate assumptions and data from a wide range of internal and external sources, such as an expected credit loss model in a financial institution that is active in different markets ~~or a technical provision relating to an insurance contract.~~
- Estimates of the development costs of a new ~~medicine~~ pharmaceutical product.
- Estimates relating to undeveloped mineral resources.
- Valuation of goodwill in a business combination.

A44J. The reasons for the auditor's assessment of the risk of material misstatement ~~as not low~~ may result from one or more ~~a combination of the factors of~~ complexity, judgment and estimation uncertainty, ~~or may be influenced primarily by one of the factors.~~ For example:

(a) A ~~Accounting~~ estimates of expected credit losses are likely ~~often to be~~ complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. they require the use of a highly specialized entity-developed model and also ~~Accounting estimates for~~ expected credit losses are also likely to involve high estimation uncertainty and significant subjectivity in making judgments about future ~~events or conditions~~ matters.

(b) A contrasting example may be ~~On the other hand,~~ an obsolescence provision for an entity with a wide range ~~array~~ of different inventory types. Making the accounting estimate may require complex systems and processes ~~to make the accounting estimate,~~ but in making the accounting estimate may involve little judgment ~~is involved~~ and the estimation uncertainty may be ~~is~~ low.

(c) ~~(a)~~ Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment such as a legal contingency about a liability, the amount of which is contingent on the outcome of the litigation.

Significant Risks

A44K. Paragraph 28 of ISA 315 (Revised) and the related application material include factors that are required to be considered when identifying significant risks. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities. ~~P46F~~²⁸

A44L. In some cases, the estimation uncertainty relating to ~~of~~ an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570 (Revised)²⁹ establishes requirements and provides guidance in such circumstances.

Other Relevant Factors

A44M. In addition to complexity, judgment and estimation uncertainty, there may be other

²⁸ ISA 315 (Revised), paragraph 29

²⁹ ISA 570, (Revised), *Going Concern*

relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement. These may include the extent to which the accounting estimate is subject to, or affected by:

- A change in the nature or circumstances of the relevant financial statement items, requirements of the applicable financial reporting framework, or regulatory factors which may give rise to the need for ~~C~~ changes in the method, assumptions or data used to make the accounting estimate;
- The susceptibility of the accounting estimate to the risk of a material misstatement due to ~~management bias or~~ fraud; and
- The regulatory environment, including relevant regulatory requirements.

Complexity

Complexity Arising from the Method Used in Making the Accounting Estimate (Ref: Para. 10(a)(i))

A44N. Methods vary in the extent to which they involve complex concepts or techniques that require management to apply specialized skills or knowledge.³⁰ In addition, the nature of the measurement basis in the applicable financial reporting framework may result in the need for a complex method that requires multiple sources of historical and forward looking data or assumptions, with complex inter-relationships between them.

A44O. Complex methods are often applied using a complex model-, particularly when the measurement basis requires the use of discounted cash flow techniques, projected or expected future cash flows and historical and forward looking data and assumptions obtained or developed from a combination of internal and external sources. Designing and operating such models often involves specialized skills or knowledge, including in relation to valuation attributes arising from the nature and circumstances of the underlying financial statement items and in the use of information technology.

A44P. Examples of accounting estimates in relation to which complex models are likely to be used include:

- An impairment loss for goodwill or an intangible asset, which may require expectations about future cash flows from the business, asset or a group of related assets to be developed based on historical data and forward looking assumptions.
- An expected credit loss, which may require expectations of future credit repayments and other cash flows, based on historical experience data and forward looking assumptions.
- An insurance contract liability, which may require expectations about future insurance contract payments to be projected based on historical experience and current and assumed future trends.
- A level 3 fair value based on cash flow projections and historical market related data.

~~The risk of material misstatement related to the method used in making the accounting estimate may arise from various sources such as:~~

³⁰ See for examples of complex techniques paragraph 8 of Appendix 2

~~The financial reporting framework. The requirements of the applicable financial reporting framework may result in the need for a complex method.~~

~~The nature of the entities' business or organizational structure. A complex organizational structure with several subsidiaries business model may give rise to errors in the not being detected within calculations or challenges in the aggregation of the data.~~

~~• The sophistication and integrity of the information systems. Data that is used to make the accounting estimates may be based on complex system-generated data which may require effective information technology general controls, and controls over the flow of data through the system.~~

~~• Fair value accounting estimates for which a highly specialized entity-developed model is used.~~

~~A44P. [Application material that explains that:~~

~~• This is the method that management uses and is not the same as the obligation for the auditor to consider whether he/she needs specialized skills or knowledge.]~~

~~• This does not mean that management needs to engage an expert~~

Complexity Arising from the Data on Which the Accounting Estimates Are Based (Ref: Para. 10(a)(ii))

A44QP. Risks of material misstatement related to c~~Complexity in making accounting estimates may arise when such complexity leads to greater difficulty in obtaining, or in maintaining the integrity of, relevant and reliable data, stemming from one or a combination of the following~~The risk of material misstatement related to the difficulty in obtaining relevant and reliable data may arise from various sources such as:

- The reliability of the data source. Data from certain sources may be more reliable than from others. For example, data obtained from internal systems outside the general and subsidiary ledgers may be more susceptible to misstatements because in some entities it may be difficult to determine whether there were appropriate controls and governance over that data ~~as they may not have been documented. The observability of the data also influences the reliability of the data source. The data that is used to make an accounting estimate may be unobservable because it is, for example, based on quotes from an inactive market. In general, the reliability of the data decreases when the data is less directly observable.~~
- ~~Information from the data source. Some external data sources will not disclose information about the data, such as how the data is accumulated, calculations in the production of the data, and the process used to generate the data (including any controls over the process that may be relevant in determining the reliability of the information provided), due to confidentiality or for proprietary reasons.~~
- Data from an external information source may be less relevant in making a fair value estimate if it is not based on observable market transactions. For example, it may be less relevant when it is based on brokers' quotes that reflect brokers' subjective judgments in the context of an inactive market. In addition, for confidentiality or proprietary reasons, some external information sources will not

(or not fully) disclose information that may be relevant in considering the relevance and reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed (including any controls over the process). It may be more difficult to consider the relevance and reliability of such data than in the case of data from more transparent external information sources.

- The sophistication and integrity of the information systems. Data that is used to make the accounting estimates may be processed by complex information systems which may require effective information technology general controls, and controls over the flow of data through the system.
- A complex organizational structure or a lack of integration between systems in different parts of the entity may give rise to difficulty in reliably and consistently aggregating.
- The complexity in preparing the data. There may be a higher risk of errors in the data when it is aggregated, compressed, transformed or otherwise modified.
- The volume of data or the source of the obtaining data, including data that comes from a wide variety of sources. This may lead, leading to a the risk that the data may be inappropriately used, or may be incomplete or from an the incorrect data set.

Judgment (Ref: Para. 10(b))

A44RQ Judgment may be used by management in the selection or application of appropriate methods, and interpretation of data and other information, the selection a of data and application of appropriate methods, and the selection and development of appropriate assumptions, and the selection or interpretation of data.

A44S. The risks of material misstatement related to judgment involved in making accounting estimates may relate to one or a combination of the following come from many sources, including:

- A lack of experience or, competence by management, including a lack of availability to management of required skills or knowledge. These factors may result in risks related to tThe selection of inappropriate methods, assumptions and data. When management lacks the competence or experience in a certain area and decides not to use a management's expert, there may be a risk that for example:
 - The method selected may not comply with the applicable financial reporting framework.
 - Management may be biased in the selection of a method, an assumption or data.
 - Management may select a data source that is not relevant and reliable.
- Indicators of management bias.
- The extent to which the applicable financial reporting framework does not specify the appropriate valuation approaches, concepts, techniques and factors to use in the estimation method and therefore, which may require significant judgment

~~through, for example, a long forecast period.~~

- ~~• Management may lack the experience or competence to interpret data, to select appropriate methods and assumptions, or consider relevant scenarios.~~
- ~~• When management lacks the competence or experience in a certain area and decides not to use a management's expert, there may be a risk that management may not make the necessary judgments that are not appropriate in light of the applicable financial reporting framework.~~
- ~~• For example, the determination of cash inflow or outflow arising from commercial supplier or customer rebates may depend on very complex contractual terms which require specific expertise or competence.~~

A44~~SR~~. Examples of accounting estimates that are ~~may have likely to be subject to~~ a high degree of judgment include the following:

- Accounting estimates that are based on expected future cash flows for which there is uncertainty regarding the amount or timing.
- Accounting estimates that are based on ~~complex legal or complex~~ contractual terms for which no evidence of legal precedent is available. For example, the determination of cash inflows or outflows arising from commercial supplier or customer rebates may depend on very complex contractual terms that require specific expertise or competence.
- Accounting estimates with a long forecast period.

A44~~TS~~. When accounting estimates are subject to ~~there is~~ a high degree of judgment, the accounting estimate may be more susceptible to the potential for management bias, particularly when this judgment involves greater subjectivity. For example, such judgment may result in a wide range of possible measurement of the accounting estimate. Management may select a point estimate amount from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated.

~~[Elaborate on point made in paragraph A44S by adding an example]~~

Estimation Uncertainty (Ref: Para. 10(c))

A44U. Estimation uncertainty arises from factors that give rise to an inherent lack of precision in the measurement of an accounting estimate. The variation in the measurement of an accounting estimate that results from estimation uncertainty is not in itself a misstatement. A risk of material misstatement related to estimation uncertainty arises from variables that increase the likelihood that management's point estimate and related disclosures are not reasonable in the context of the applicable financial reporting framework.

A44V. Estimation uncertainty may arise, for example, when it is not possible (or not practical, insofar as permitted by the applicable financial reporting framework) for management:

- To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount that will be settled for a future

insurance claim); or

- To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A44W.T. The risk of material misstatement related to estimation uncertainty may relate to one or a combination of the following~~arise from various sources such as:~~

- The applicable financial reporting framework, which may require:
 - The use of a~~A~~ method ~~used~~ to make the accounting estimates that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of a level 3 fair value~~the use of fair value accounting instead of historical costs.~~
 - The use of assumptions that inherently have a high level of estimation uncertainty, such as future cash flows for a long-term contract, ~~or~~ assumptions that are based on data that is unobservable and are therefore difficult for management to develop or the use of the various assumptions that are interrelated.
 - Disclosures about estimation uncertainty. There may be a risk of material misstatement related to the failure to make a material disclosure about the estimation uncertainty.
- _____ The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate assumption~~may~~ therefore be dependent on data that is not readily~~are hard to~~ observable.

A47. Examples of accounting estimates that may have high estimation uncertainty include the following:

- ~~Accounting estimates that are not determined using recognized measurement techniques.~~
- ~~Accounting estimates where the results of the auditor's review of similar accounting estimates made in the prior period financial statements indicate a substantial difference between the original accounting estimate and the actual outcome.~~

A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the accounting estimate~~estimation~~; that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate ~~may not be~~ is not, in itself, an indicator of its estimation uncertainty.

A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that the significant risks~~relate~~ not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness~~adequacy~~ of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high

estimation uncertainty associated with them (see paragraphs A120-A123).

~~A49A5.~~ Not all accounting estimates ~~are affected~~~~inve by~~~~ve~~ high levels of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.

~~The Sensitivity of the Accounting Estimate to Changes in Particular Data, Assumptions and Methods~~

~~A49BA.~~ As described in paragraph A38A, some accounting estimates may be particularly sensitive to certain data, assumptions, and methods. For these accounting estimates the sensitivity may influence the degree of estimation uncertainty associated with an accounting estimate, which in turn may influence the accounting estimate's susceptibility to management bias. In these circumstances the auditor's application of professional skepticism is particularly important and the auditor may, for example, compare its own independent analysis of the data and assumptions with management's, including obtaining an understanding of any differences between them.

~~A49BA.~~ A sensitivity analysis may ~~demonstrate that an accounting estimate is not sensitive to changes in particular assumptions.~~ Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.

~~A49CA59U.~~ The degree of estimation uncertainty associated with an accounting estimate may influence its susceptibility to management bias. When the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor's application of professional skepticism is particularly important.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 13)

~~A57A.~~In designing further audit procedures, ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance or disclosure (that is, the inherent risk), and whether the risk assessment takes account of relevant controls (that is, control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively.

~~A57B.~~Paragraph A40 of ISA 200³¹ states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, the auditor may make separate or combined assessments of inherent and control risk. Although this ISA neither implies nor requires a separate assessment of inherent and control risk, it highlights the importance of the

³¹ ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

auditor's consideration of both inherent and control risk in designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level in accordance with ISA 330.

A57C. —In identifying the risks of material misstatement for accounting estimates, paragraph 10 requires the auditor to take into account the extent to which the estimate is subject to, or affected by relevant factors, including complexity, the need for the use of judgment by management in making the accounting estimate, and estimation uncertainty (i.e., the reasons for the assessment given to the risk of material misstatement).

A57D. —Accounting estimates, by their nature, will vary and be subject to differing levels of assessed risk of material misstatement. Therefore, the nature, timing and extent of the further audit procedures performed to respond to the assessed risks of material misstatement at the assertion level, in accordance with ISA 330, will also vary in relation to the nature of the accounting estimate, the level of assessed risk and the reasons for the assessment given to the risk.

A57E. —In certain circumstances, ~~Some entities, such as large banks, insurers, and telecommunication entities, make extensive use of IT to conduct their business or have a high number of accounting estimates, many of which are judgmental or complex, in their financial reports. For audits of these entities, it~~ may not be possible or practicable for the auditor to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level ~~for certain accounting estimates.~~ For example, this may be the case for entities such as large banks, insurers, and telecommunication entities, that make extensive use of IT to conduct their business or have a high large number of accounting estimates, many of which are highly judgmental or complex. Other factors that may indicate that substantive procedures alone may not be able to provide sufficient appropriate audit evidence at the assertion level include:

- The volume of transactions (for example, a high volume of transactions may occur in a large bank, insurer or telecommunication entity, making it more difficult to design substantive procedures that may alone provide sufficient appropriate audit evidence at the assertion level).
- Whether significant information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported. For such assertions, audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information. In addition, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.
- The need to combine information from the general ledger and subsidiary ledgers with information obtained from outside the general and subsidiary ledgers (for example, an expected credit loss may require information from the entity's risk management system). In these situations, it may not be possible to design and perform substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level.

~~A57F.~~ In some jurisdictions, as part of the audit of the financial statements for certain entities (such as a bank or insurer), the auditor also may be required by law or regulation to undertake additional work to provide assurance on internal controls.

~~A57C. Testing the operating effectiveness of controls over how management made the accounting estimate may be an appropriate response when management's process has been well-designed, implemented and maintained, for example:~~

- ~~• Controls exist for the review and approval of the accounting estimates by appropriate levels of management and, where appropriate, by those charged with governance.~~
- ~~• The accounting estimate is derived from the routine processing of data by the entity's accounting system.~~
- ~~• Management's method of making the accounting estimate involves a large volume of data, processing by IT systems, or large volumes of transactions (for example, for an entity with an actively managed portfolio of investments).~~

Considerations Specific to Smaller Entities

~~A57G.D~~ Controls over the process to make an accounting estimate may exist in smaller entities, but ~~the~~ their formality ~~with which they operate may~~ vary ies. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is more likely to be substantive in nature, ~~with the auditor performing one or more of the other responses in paragraph 13.~~

~~A57E. In designing further audit procedures, ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance or disclosure (that is, the inherent risk), and whether the risk assessment takes account of relevant controls (that is, control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively.~~

~~A57F. Paragraph A40 of ISA 200 states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, the auditor may make separate or combined assessments of inherent and control risk. Although this ISA neither implies nor requires a separate assessment of inherent and control risk, it highlights the importance of the auditor's consideration of both inherent and control risk in designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level in accordance with ISA 330.~~

~~A57G. In identifying the risks of material misstatement for accounting estimates, paragraph 10 requires the auditor to take into account the extent to which the estimate is subject to, or affected by, complexity or use of judgment by management in making the accounting estimate, estimation uncertainty, or other relevant factors (i.e., the reasons for the assessment given to the risk of material misstatement).~~

~~[To align with final wording in paragraph 10]~~

~~A57H. Accounting estimates, by their nature, will vary and be subject to differing levels of assessed risk of material misstatement, and different reasons for the assessment given to those assessed risks. Therefore, the nature, timing and extent of the procedures performed to respond to the assessed risks of material misstatement at the assertion level, in accordance with ISA 330, will also vary in relation to the nature of the accounting estimate, the level of assessed risk and the reasons for the assessment given to the risk.~~

Accounting Estimates with Low Assessed Risk of Material Misstatement ~~But~~ Not Because that -Assessment ~~Does Not Include~~ An Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(a))

~~A57I~~A57H. For some accounting estimates, such as those described in paragraph ~~A44J~~, the extent to which they are affected by, or subject to, ~~of~~ complexity, the need for the use of judgment, ~~or and~~ estimation uncertainty may be such that the assessed risk of material misstatement at the assertion level is low, but not because ~~and~~ that assessment ~~does not include~~ s an expectation that relevant controls are operating effectively (in other words, the assessed risk of material misstatement is primarily influenced by lower inherent risk). In these circumstances, the auditor may determine that a procedure that addresses management's point estimate at an overall level ~~an overall procedure,~~ is sufficiently responsive to the assessed risk of material misstatement. ~~This might be the case when the sale of the complete inventory of a superseded product shortly after the period end provides sufficient appropriate evidence relating to the estimate of its net realizable value.~~ For such accounting estimates, the following procedures may be appropriate:

- Obtaining audit evidence about events occurring up to the date of the auditor's report;
- Developing a point estimate or range based on available audit evidence to evaluate management's point estimate; and/or
- ~~Performing substantive analytical procedures.~~
- ~~If an overall procedure is not sufficiently responsive to the risk of material misstatement, the auditor may find paragraphs 13A-C useful in designing further audit procedures.~~

Accounting Estimates with Low Assessed Risk of Material Misstatement and that Assessment Includes an Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(b))

~~A57JA~~A57I. As indicated in paragraph 13(b), the auditor may have assessed the risk of material misstatement as low based on and that assessment includes an expectation that relevant controls are operating effectively. When this is the case, the auditor is required to perform tests of the relevant controls to obtain audit evidence ~~of~~ about their operating effectiveness in accordance with ISA 330.

~~A57JA~~. In some circumstances, the tests of controls may not be sufficient, by themselves, to appropriately address the factors reasons for the giving rise to the ~~assessment given to~~ ed the risk of material misstatement. If not, the auditor is required by ISA 330 to perform substantive procedures. ~~In other circumstances, the tests of controls may be sufficient to respond to the assessed risks of material misstatement for certain assertions, but not others.~~

Accounting Estimates with an Assessed Risk of Material Misstatement that is Not Low (Ref. Para: 13(c))

A57JK. ~~On the other hand, f~~For some accounting estimates, such as those described in paragraph ~~A44KA44J~~, the extent of complexity, judgment or estimation uncertainty (either individually or in combination) is more likely to influence the auditor's assessment of the risk of material misstatement for the estimate (that is, the auditor's assessment of the risk of material misstatement may be higher as the extent of complexity, judgment and estimation uncertainty involved increases).

A57KL. In these circumstances, paragraph 13(c) requires the auditor to design and perform further audit procedures (whether substantive procedures or tests of controls) to obtain audit evidence about the matters in paragraphs 13A to 13C, when applicable. Such procedures address thealso are required to be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needed.

A57LM. ~~Paragraphs 13A to 13C describe the types of matters that the auditor is required to address in designing and performing further audit procedures when the assessed risk of material misstatement is not low.~~ As explained in ISA 330,³² the nature of the procedures is of most importance in responding to the assessed risks. In addition, the reasons for the assessment given to a risk are relevant in determining the nature of audit procedures.³³ ~~Therefore, the auditor's consideration of inherent risk is particularly important in designing the further audit procedures because the auditor's assessment of the risk of material misstatement may be higher as the extent of complexity, judgment and estimation uncertainty involved increases, as noted in paragraph A58H.~~ The timing and extent of the further audit procedures will vary based on the assessed risk of material misstatement.

Complexity (Ref: Para. 13A)

A57O. ~~In obtaining [sufficient appropriate] audit evidence about the matters in paragraphs 13A-13C, management's use of IT (for example, in making the accounting estimate, processing data, or making calculations) is an important consideration. Appropriate Use of Specialized Skills and Knowledge by Management (Ref: Para. 13A(a))~~

A59A7P. When management uses a complex's method ~~necessarily involves specialized skills or knowledge~~, an important factor that the auditor may need to consider regarding the appropriateness of the method, and significant data and assumptions, obtaining audit evidence about is whether there were other ~~reasonably~~ available valuation concepts, techniques or factors, types of assumptions or sources of data that, in the circumstances, might have been more appropriate, or more generally accepted, in the context of the applicable financial reporting framework. The auditor may also consider whether management was able to obtain access to the appropriate skills and knowledge involved in applying the complex method.

³² ISA 330, paragraph A5

³³ ISA 330, paragraph A10

Complex Modelling

A59AA59B. In some cases, management may use a complex model to make an accounting estimate. Whether the complex model used is appropriate in the context of the applicable financial reporting framework may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific item being measured.

A59CPB. The nature and extent of the procedures that may be performed with respect to the complex model depends on its complexity. When complex modelling is needed, the assessed risk of material misstatement is likely to be higher and, therefore, the more persuasive the audit evidence that may need to be obtained.

A59DPC. The extent to which the following considerations are relevant depends on the circumstances, including whether the complex model is obtained from a third-party, or is a proprietary model. Depending on the circumstances, matters that the auditor may consider include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity;
 - The accuracy and completeness of the model's data and assumptions; and
 - The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.

Understanding or Interpreting Data (Ref: Para. 13A(c))

~~A57Q. ISA 500 contains requirements and guidance regarding the auditor's responsibilities to consider the relevance and reliability of information to be used as audit evidence. For data (and other information used to develop assumptions) to which the accounting estimate is particularly sensitive is relevant and reliable, the auditor may design and perform procedures to address the matters below:~~

- ~~• Whether the data is relevant and reliable in the context of the estimation method and the financial reporting framework; and~~
- ~~• Whether the integrity of the data has been maintained in applying the method, may be important.~~

~~A59A. A sensitivity analysis may demonstrate that an accounting estimate is not sensitive to changes in particular assumptions. Alternatively, it may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.~~

A59ABE. An accounting estimate may be based on data that needs to be understood or interpreted. For example, a contract may include complex terms that management needs to understand and interpret based on the facts and circumstances of the entity.

Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract;
- EnquireInquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts, and:
 - Obtaining an understanding of, and evaluating, the underlying business purpose for the transaction or agreement; and
 - Considering whether the terms of the contracts are consistent with management's explanations.

Evaluating the Use of Models (Ref: Para. 13A(b))

~~A59B. In some cases, management may use a model to make an accounting estimate. Whether the model used is appropriate in the circumstances may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific asset or liability being measured.~~

~~A59C. The nature and extent of the procedures to be performed with respect to the model depends on its complexity. When a complex model is used, the assessed risk of material misstatement is likely to be higher and, therefore, the more persuasive the audit evidence that may need to be obtained. Therefore, the procedures done to meet paragraphs 13(a)(i) and (ii) may be more extensive than for other models~~

~~A59D. The extent to which the following considerations are relevant depends on the circumstances, including whether the model is one that is commercially available for use in a particular sector or industry, or a proprietary model. In some cases, an entity may use an expert to develop and test a model.~~

~~A59E. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:~~

- ~~• The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:~~
 - ~~• The model's theoretical soundness;~~
 - ~~• The model's mathematical integrity;~~
 - ~~• The accuracy and completeness of the model's data and assumptions; and~~
 - ~~• The model's output as compared to actual transactions.~~
- ~~• Appropriate change control policies and procedures exist.~~

Integrity of Significant Data and Assumptions (Ref: Para. 13A(d))

~~A59FEA. Data may be developed internally, or may be obtained from an external information source. When obtaining audit evidence about the integrity of data and assumptions, it may be appropriate for the auditor to compare the data and assumptions with an external information source.~~

External information sources

~~A59G. ISA 500 contains requirements and guidance regarding audit evidence considerations when an external information source is used.~~

Data from outside the general and subsidiary ledgers

Judgment

Management's The Selection of Methods and the Significant Data and Assumptions ~~and Data~~ (Ref: Para. 13B(a)(ii))

~~A59GJ. Audit evidence regarding~~Support for management's selection of methods and significant data and assumptions may be obtained~~derived~~ from inquiries of management regarding's knowledge may be obtained from management's continuing processes of strategic analysis and risk management and inspection of relevant documents (such as committee minutes). Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the significant data and assumptions through inquiries of, and discussions with, management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

Changes From Previous Periods in the Method, or the Significant Data or Assumptions (Ref: Para. 13B(a)(ii))

A59HJA. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias. (see paragraphs A121B–A121F).

A59IJB. Management often is able to demonstrate good reason for a change in an accounting estimate, the method for making an accounting estimate, or the significant data or assumptions used from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

Consistency and Consideration of Alternative Assumptions (Ref: Para. 13B(a)(iAii))

~~A59JK. In~~As part of the process of making changes to the methods, assumptions, and data used in previous periods, mManagement may evaluate alternative assumptions or outcomes of the accounting estimates, which can be accomplished through a number of ~~methods~~approaches, depending on the circumstances. One possible ~~method used by management~~approach is ~~to undertake~~ a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as “pessimistic” and “optimistic” scenarios.

A59~~K~~L. This is not intended to suggest that one particular ~~method approach~~ is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed the effect on the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate (see paragraph 13C(a)).

Considerations specific to smaller entities

A59~~L~~M. Smaller entities may use simple means to assess alternative assumptions or outcomes. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management's consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative assumptions or outcomes and, therefore, may need to obtain specialized skills or knowledge from an external party (see also paragraph 8(c)(iii)). ~~In such cases, the auditor may explain to management the process or the different methods available for doing so, and the documentation thereof. This would not, however, change the responsibilities of management for the preparation of the financial statements.~~

~~Complex Contractual Terms (Ref: Para. 13B(a)(iv))~~

~~A59N. An accounting estimate may be based on data that needs to be interpreted. For example, a contract may include complex terms that management need to understand and interpret based on the facts and circumstances of the entity. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:~~

- ~~• Consider whether specialized skills or knowledge are needed to obtain sufficient appropriate audit evidence;~~
- ~~• Enquire of the entity's legal counsel regarding the legal or contractual terms;~~
- ~~• Confirm the completeness of the contractual terms with the counterparty;~~
- ~~• Inspect the underlying contracts, and;~~
- ~~• Obtain an understanding of, and evaluate, the underlying business purpose for the transaction or agreement;~~
- ~~• The terms of the contracts are consistent with management's explanations; and~~
- ~~• The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework~~

~~Changes in Methods, Assumptions and Data (Ref: Para. 13B(a)(vi))~~

~~A59P. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give~~

~~rise to a financial statement misstatement or be an indicator of possible management bias.~~

~~A59Q. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.~~

~~Inactive markets~~

~~A59R. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.~~

Management's Intent and Ability (Ref: Para. 13B(b))

A59~~MS~~. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorizations or minutes.
- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the entity's ability to carry out the course of action.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

Evaluating the Use of Model Adjustments (Ref: Para. 13B(c)(iii))

~~A59N.F. Depending on the circumstances, matters that the auditor may also consider in testing the model include, for example, whether:~~

~~The model is periodically calibrated and tested for validity, particularly when assumptions are subjective.~~

~~When management has made adjustments are made to the output of the model (see paragraph A25A to meet the requirements of the applicable financial reporting framework, consideration of those adjustments is likely to be important in obtaining sufficient appropriate audit evidence over risks of material misstatement related to the use of judgment by management. Several types of methods used for the valuation of accounting estimates that require adjustments are for example, fulfilment value accounting for valuing insurance contracts and overlay adjustments when accounting for expected credit losses. In the case of fair value accounting estimates, it may be relevant to consider whether such adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.~~

- ~~• The model is adequately documented, including the model's intended applications and limitations and its key parameters, required assumptions, and results of any validation analysis performed.~~

Estimation Uncertainty (Ref: Para. 13C)

Management's Steps to Understand and Address Estimation Uncertainty (Ref: Para. 13C(a))

~~A59O.UA. When evaluating the steps, if any, management has taken to understand and address estimation uncertainty, the auditor may consider whether the method's (or including, when applicable, the model's) design minimizes estimation uncertainty. In this regard, testing the operating effectiveness of controls that are intended to minimize estimation uncertainty may be useful.~~

Reasonableness of Management's Point Estimate or Range (Ref: Para 13C(a)(i))

~~A59W. In preparing the financial statements, management may be satisfied that it has adequately addressed the effects of estimation uncertainty. In some circumstances, however, the auditor may view the efforts of management as inadequate. This may be the case, for example, where, in the auditor's judgment:~~

- ~~• Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.~~
- ~~• It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.~~

- ~~It is unlikely that other audit evidence can be obtained, for example, through the review of events occurring up to the date of the auditor's report.~~
- ~~Indicators of management bias in the making of accounting estimates may exist.~~

~~A59X. When the auditor believes that the efforts of management are inadequate, the auditor may consider requesting management to consider alternative assumptions or to provide additional disclosure relating to the estimation uncertainty.~~

~~A59Y. [Application material to explain that the auditor may develop a point estimate or range in a variety of ways independently from management. In some cases, it may be sufficient to, including using management's model and flexing the assumptions, data sources, etc. and that the auditor may develop a point estimate or range over only part of the accounting estimate].~~

~~A59Z. [Application material to explain that, while it is common for the audit evidence to provide the auditor with the opportunity to narrow the range, in some cases, the audit evidence may instead point to a wider range. This would imply a high level of estimation uncertainty, and may have implications for the auditor's report.]~~

Disclosures of eEstimation Uncertainty for aAccounting eEstimates (Ref: Para 13C(a)(ii)(b))

A60A. Even when re the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is inadequate-unreasonable in light of the circumstances and facts involved. The auditor's evaluation of the adequacy-reasonableness of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see related discussion in paragraphs A94A60K-A60L).

A60B. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. ISA 705 (Revised)³⁴ provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosure of estimation uncertainty in the financial statements is inadequate or misleading. If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter (see ISA 701)³⁵.

When Management Point Estimate or Range Has Not Adequately-Appropriately Addressed Estimation Uncertainty (Ref: Para. 13C(b))

A60C. In preparing the financial statements, management may be satisfied that it has appropriately addressed the effects of estimation uncertainty. In some circumstances, however, the auditor may view the efforts of management as inappropriate. This may be the case, for example, when, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.

³⁴ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

³⁵ ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report

- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other information can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A60D. When the auditor believes that the efforts of management are inappropriate, the auditor may consider requesting management to consider alternative assumptions or to provide additional disclosure relating to the estimation uncertainty.

~~A60E.~~ If, in the auditor's judgment, management has not ~~adequately appropriately~~ addressed the effect of estimation uncertainty, the auditor is required to develop a point estimate or a range to enable the auditor to evaluate the reasonableness of management's point estimate and the disclosures in the financial statements that describe the estimation uncertainty.

A60F. When developing a point estimate or range, the auditor may –and– uses different assumptions or a different method different from those used by management. –It is important for the auditor to obtaining a sufficient understanding of the assumptions or method used by management in making the accounting estimate– is important in evaluating management's point estimate. This is because understanding management's assumptions or methods as these provides the auditor with information that may be relevant to the auditor's development of an appropriate point estimate or range and to understand the differences between the auditor's point estimate or range and management's. Further, it assists the auditor to understand and evaluate any significant differences from management's point estimate.

A60G. For example, a difference may arise because the auditor used different, but equally valid, assumptions as compared with those used by management, but both sets of assumptions are equally could be valid in the context of the applicable financial reporting framework. This may reveal that the accounting estimate is highly sensitive to certain assumptions and therefore subject to high estimation uncertainty, indicating that the accounting estimate may be a significant risk. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

~~A60E. Developing a point estimate or a range to evaluate management's point estimate may be an appropriate response where, for example:~~

- ~~An accounting estimate is not derived from the routine processing of data by the accounting system.~~
- ~~The auditor's review of similar accounting estimates made in the prior period financial statements suggests that management's current period process is unlikely to be effective.~~
- ~~The entity's controls within and over management's processes for determining accounting estimates are not well designed or properly implemented.~~

- ~~Events or transactions between the period end and the date of the auditor's report contradict management's point estimate.~~
- ~~There are alternative sources of relevant data available to the auditor which can be used in developing a point estimate or a range.~~

~~A60F. Even where the entity's controls are well designed and properly implemented, developing a point estimate or a range may be an effective or efficient response to the assessed risks. In other situations, the auditor may consider this approach as part of determining whether further procedures are necessary and, if so, their nature and extent.~~

A60H. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a ~~preliminary~~ point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, ~~where~~ when possible, a point estimate.

A60H. The ability of the auditor to develop a point estimate, as opposed to a range, depends on several factors, including the ~~model~~ method used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value, or the most likely outcome).

A60J. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Using management's model and selecting alternative assumptions or data sources to develop a point estimate or range.
- Developing a point estimate or range for only part of the accounting estimate (for example, when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A60K. The appropriate methods, ~~data, and~~ assumption and data to use depend on the requirements of the applicable financial reporting framework, and other factors. ~~Obtaining an understanding of management's assumptions or methods aids the auditor evaluating management's point estimate in establishing that the auditor's point estimate or range takes into account relevant variables and enables the auditor in evaluating significant differences from management's point estimate.~~

~~Narrowing a~~The Boundaries of a Range (Ref: Para. 13C(~~bc~~))

A60L~~K~~. A range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit. ~~The auditor's range is useful and effective when it is sufficiently narrow to enable the auditor to conclude whether the accounting estimate is misstated.~~

A60M~~L~~. Ordinarily, a range that has been narrowed to ~~be~~equal to or less than performance materiality is adequate for the purposes of evaluating the reasonableness of management's point estimate. However, particularly ~~i~~n certain industries, such as financial services or extractive industries, it may not be possible to ~~narrow~~develop athe range ~~to below such an amount~~within performance materiality and, in some cases, may be multiples of performance materiality. This does not necessarily preclude recognition of the accounting estimate based on the audit evidence obtained. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk.

A60M~~M~~. ~~Narrowing the range to a position where all outcomes within the range are considered reasonable may be achieved by:~~

- ~~(a) Eliminating from the range those outcomes at the extremities of the range judged by the auditor to be unlikely to occur; and~~
- ~~(b) Continuing to narrow the range, based on audit evidence available, until the auditor concludes that all outcomes within the range are considered reasonable. In some rare cases, the auditor may be able to narrow the range until the audit evidence indicates a point estimate.~~
- ~~(c) Using an expert~~
- ~~(d) Considering whether alternative data or assumptions are more relevant and reliable than those selected by management (in light of the requirements of the applicable financial reporting framework) and, accordingly, if using of those alternative data or assumptions would result in an outcome that is within performance materiality~~

Disclosures Related to Accounting Estimates (Ref: Para.13D)

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

- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
 - Assumptions developed internally ~~that may affect an asset's useful life~~; or

- ~~Data, such as interest rates, that are affected by factors outside the control of the entity.~~
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.
- Fair value information, including when that is produced by management's experts.
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are reasonable in accordance with the requirements of the applicable financial reporting framework.

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

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

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

A121A. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation may include the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. Depending on the facts and circumstances, given the importance of accounting estimates to the overall financial statements, the auditor may determine that additional disclosures related to accounting estimates are necessary to

achieve fair presentation. This may be the case, for example, when an accounting estimate is subject to significant estimation uncertainty (see paragraphs A122-A123).

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 13E)

A121B. ISA 330³⁶ notes that an audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable, that differs significantly from the information on which the risk assessment was based.

A121C. For example, the auditor may have identified that the reasons for an assessed risk of material misstatement are limited to the judgment used by management in making the accounting estimate. However, while performing procedures to address the matters in paragraph 13B, as applicable, the auditor may discover that the accounting estimate is more complex than originally contemplated, and indicating that the assessment of the risk of material misstatement may need to be revised (that is, the reasons for the assessment now include complexity). Therefore, the auditor may need to perform additional audit procedures to address the matters in paragraph 13A, as applicable. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.³⁷

~~Where management has recognized and disclosed an accounting estimate in the financial statements, the focus of the auditor's evaluation is on whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework.~~

A121D. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation is may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. Even where When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, there may be a need for disclosure of the circumstances in the notes to the financial statements. Where applicable, the auditor may also determine that an accounting estimate that has been identified as having a high estimation uncertainty is a key audit matter to be communicated in the auditor's report in accordance with ISA 701,³⁸ or may consider it necessary to include an Emphasis of Matter paragraph in the auditor's report (see ISA 706 (Revised)).³⁹ If the matter is determined to be a key audit matter, ISA 706 (Revised) prohibits the auditor from including an Emphasis of Matter paragraph in the auditor's report.⁴⁰ some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

~~A121D. Many financial reporting frameworks prescribe certain conditions for the recognition of accounting estimates and specify the methods for making them and required disclosures.~~

³⁶ ISA 330, paragraph A60

³⁷ ISA 315, paragraph 31

³⁸ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

³⁹ ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

⁴⁰ ISA 706 (Revised), paragraph 8(b)

~~Such requirements may be complex and require the application of judgment. Based on the understanding obtained in performing risk assessment procedures, the requirements of the applicable financial reporting framework that may be susceptible to misapplication or differing interpretations become the focus of the auditor's attention.~~

~~A121E. Determining whether management has appropriately applied the requirements of the applicable financial reporting framework is based, in part, on the auditor's understanding of the entity and its environment. For example, the measurement of the fair value of some items, such as intangible assets acquired in a business combination, may involve special considerations that are affected by the nature of the entity and its operations.~~

~~A121F. In some situations, additional audit procedures, such as the inspection by the auditor of the current physical condition of an asset, may be necessary to determine whether management has appropriately applied the requirements of the applicable financial reporting framework.~~

~~A121G. The application of the requirements of the applicable financial reporting framework requires management to consider changes in the environment or circumstances that affect the entity. For example, the introduction of an active market for a particular class of asset or liability may indicate that the use of discounted cash flows to estimate the fair value of such asset or liability is no longer appropriate.~~

~~A121H. Areas where particular skills and knowledge may be required include:~~

- ~~• Whether those involved in developing and applying the valuation technique have the appropriate skills and expertise to do so, including whether a management's expert has been used; and~~
- ~~• Understanding the legal, regulatory, and tax implications resulting from the accounting estimate, including whether the contracts are enforceable by the entity (for example, reviewing the underlying contracts), may require specialized skills and knowledge.~~

~~A121I. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is considered arbitrary. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias.~~

~~A121J. Management often is able to demonstrate good reason for a change in an accounting estimate or the method for making an accounting estimate from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.~~

~~A121K. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. As markets become inactive, the change in circumstances may lead to a move from valuation by market price to valuation by model, or may result in a change from one particular model to another. Reacting to changes in market conditions may be difficult if management does not have policies in place prior to their occurrence. Management may also not possess the expertise necessary to develop~~

~~a model on an urgent basis, or select the valuation technique that may be appropriate in the circumstances. Even where valuation techniques have been consistently used, there is a need for management to examine the continuing appropriateness of the valuation techniques and assumptions used for determining valuation of financial instruments. Further, valuation techniques may have been selected in times where reasonable market information was available, but may not provide reasonable valuations in times of unanticipated stress.~~

~~A121L. With respect to fair value accounting estimates, some financial reporting frameworks presume that fair value can be measured reliably as a prerequisite to either requiring or permitting fair value measurements and disclosures. In some cases, this presumption may be overcome when, for example, there is no appropriate method or basis for measurement. In such cases, the focus of the auditor's evaluation is on whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.~~

Misstatements (Ref: Para.13~~EE(d)~~)

A121E. ISA 450⁴¹ provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

A121F124M. Based on the audit evidence obtained, the auditor may conclude that there is sufficient appropriate audit evidence supporting a point estimate that does not differ from management's point estimate, or a range that includes management's point estimate, which may lead the auditor to conclude that the accounting estimate is reasonable in the context of the applicable financial reporting framework.~~the evidence points to an accounting estimate that differs from management's point estimate.~~

A121GX8. Alternatively, the audit evidence may support a point estimate that differs from management's point estimate, or a range that does not include management's point estimate. When the audit evidence supports an auditor's point estimate that differs from management's point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the audit evidence supports a range that does not encompass management's point estimate, the difference between management's point estimate and a point in the auditor's range is a misstatement. In such cases, the misstatement is not less than the difference between management's point estimate and the nearest point of the auditor's range, but could be greater.

⁴¹ ISA 450, *Evaluation of Misstatements Identified during the Audit*

~~Where the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Where the auditor has concluded that using the auditor's range provides sufficient appropriate audit evidence, a management point estimate that lies outside the auditor's range would not be supported by audit evidence. In such cases, the misstatement is not less than the difference between management's point estimate and the nearest point of the auditor's range, but could be greater if, for example, the evidence supported a point estimate within the auditor's range.~~

~~A121N. Where management has changed an accounting estimate, or the method in making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias (see paragraphs A124–A125).~~

~~A121O. ISA 450⁴² provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:~~

- ~~• Misstatements about which there is no doubt (factual misstatements).~~
- ~~• Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).~~
- ~~• The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).~~

~~In some cases involving accounting estimates, a misstatement could arise as a result of a combination of these circumstances, making separate identification difficult or impossible.~~

~~A121H121P. Evaluating whether sufficient appropriate audit evidence has been obtained, and whether the accounting estimate is misstated, for accounting estimates and related disclosures included in the notes to the financial statements, whether required by the applicable financial reporting framework or disclosed voluntarily, involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.~~

Indicators of Possible Management Bias (Ref: Para. 21)

A121I. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.

⁴² — ISA 450, *Evaluation of Misstatements Identified during the Audit*

- Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

A121J. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of bias. For example, when management has changed an accounting estimate, or the method of making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence obtained that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias.

A121K. Management bias ~~can~~ may be more difficult to detect at an account level than when considering groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A121L. For example, if each accounting estimate included in the financial statements was individually reasonable but each management point estimate trends toward one end of the auditor's range, such circumstances may indicate possible bias by management in making the estimates. Bias may also be evident from the cumulative effect of changes in multiple accounting estimates. For example, if the estimates in the financial statements are grouped at one end of the range of reasonable outcomes in the prior year and are grouped at the other end of the range of reasonable outcomes in the current year, such changes may be an indicator of possible bias in seeking to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

A121M. Indicators of management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in ISA 700 (Revised).

A121N. ~~The preparation of the financial statements requires management to make a number of judgments or assumptions that affect significant accounting estimates and to monitor the reasonableness of such estimates on an ongoing basis. In addition, in applying ISA 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include . This may be achieved by, for example, intentionally understating or overstating all provisions or reserves in the accounting estimates same fashion so as to be designed either to smooth earnings over two or more accounting periods, or to achieve a designated earnings level in order to deceive financial statement users by influencing their perceptions as to the entity's performance and profitability. Possible indicators of management bias that may also be indicators of a fraud risk may cause the auditor to reassess whether the auditor's risk assessments, in particular the~~

assessment of fraud risks, and related responses remain appropriate.

~~A124. During the audit, the auditor may become aware of judgments and decisions made by management which give rise to indicators of possible management bias. Such indicators do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates but may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in ISA 700 (Revised).~~

~~A125. Examples of indicators of possible management bias with respect to accounting estimates include:~~

- ~~• Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.~~
- ~~• Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.~~
- ~~• Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.~~
- ~~• Selection of a point estimate that may indicate a pattern of optimism or pessimism.~~

Written Representations (Ref: Para. 22)

A126. ISA 580⁴³ discusses the use of written representations. In ~~addition to~~ obtaining written representations that management and, where appropriate, those charged with governance believe the methods and significant data and assumptions used in making the accounting estimates and their related disclosures are ~~reasonable appropriate~~, the auditor ~~is required to consider the need may, depending on the nature and materiality of the accounting estimate and the extent to which the method for making it, or its related disclosure, is affected by, or subject to, estimation uncertainty, complexity, use of judgment, or other risk factor, determine that it is necessary to obtain one or more further specific written representations about specific accounting estimates. These representations may address accounting estimates recognized or disclosed, or about decisions not to recognize or disclose an accounting estimate, in the financial statements and This~~ may include representations:

- About the appropriateness of the method selected, ~~and, where applicable, the model used~~, for making the accounting estimate in the context of the applicable financial reporting framework;⁷
- That the ~~significant~~ assumptions and data sources, ~~including any external information sources~~,⁷ used as inputs in making the accounting estimates, are relevant, reliable and appropriate in the context of the applicable financial reporting framework;⁷

⁴³ ISA 580, *Written Representations*

- That the significant judgments made in making the accounting estimate have been taken into account all relevant information of which management is aware relevant to making those judgments.
- About the consistency in the selection or application of the method, data, and assumptions and data used by management in determining making the accounting estimates in the context of the applicable financial reporting framework.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and appropriate under the applicable financial reporting framework.
- That appropriate specialized skills or expertise, where necessary, has been applied in making the accounting estimates;
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognized or disclosed in the financial statements, written representations may also include representations about:

The appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).

- ~~The appropriateness of the basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework, for those accounting estimates not measured or disclosed at fair value (see paragraph A115).~~

Communication with Those Charged With Governance (Ref: Para 22A)

A127A. In applying ISA 260 (Revised), and, when applicable, ISA 265⁴⁴, the auditor communicates to with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures. This may include, and, when applicable, why the auditor considers a significant accounting practice, which include management's judgments in making the accounting estimates, although acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity. In communicating those views, matters specific to the accounting estimates that the auditor may consider communicating to those charged with governance include:

- (a) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
- (b) The relative materiality of the accounting estimates to the financial statements as a whole;

⁴⁴ ~~ISA 265, Communicating Deficiencies in Internal Control To Those Charged With Governance And Management~~

- (c) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates, particularly financial instruments;
- ~~(d)~~ Significant deficiencies in the internal control or risk management systems that are relevant to accounting estimates;
- ~~(e)~~(d) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external data source or valuations performed by management or a management's expert;
- ~~(f)~~(e) Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
- ~~(g)~~(f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate;
- ~~(h)~~(g) The auditor's views about the appropriateness of the selection of accounting policies and presentation of accounting estimates in the financial statements;
- ~~(i)~~(h) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for accounting estimates; and
- ~~(j)~~(i) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates.

A121B. In applying ISA 265, the auditor communicates significant deficiencies in internal control to those charged with governance or management, including significant deficiencies regarding accounting estimates. Such communications may include, for example, significant deficiencies related to controls over:

- (a) The selection and application of significant accounting policies related to accounting estimates, and the selection and application of methods, assumptions, and data;
- (b) Risk management and related systems;
- (c) Data integrity, including when data is obtained from an external information source; and
- (d) The use, development and validation of models, including third-party models, and any adjustments that may be required; and

A127C~~B~~. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators or prudential supervisors, ~~in addition to those charged with governance~~. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, in some jurisdictions, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while other regulators may seek to understand the auditor's views on significant aspects of the entity's operations including the entity's costs estimates. This communication may be helpful to the auditor in identifying risks of material misstatement.

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A121E5 for examples of indicators of possible management bias.

Appendix 1

(Ref: Para. 2A–2B)

Measurement Bases of Accounting Estimates

1. The purpose of this appendix is to explain the range of different types of measurement bases that may be used in making accounting estimates. It is intended to provide context for the auditor's consideration of the extent to which the factors of complexity, the need for the use of judgment, and estimation uncertainty may be inherent in the use of a particular measurement basis.
- 2A1. Because of the uncertainties inherent in business activities, some financial statement items can only be estimated. Further, the specific characteristics of an asset, liability or component of equity, or the basis of or method of measurement prescribed by the financial reporting framework, may give rise to the need to estimate a financial statement item. Some financial reporting frameworks prescribe specific methods of measurement and the disclosures that are required to be made in the financial statements, while other financial reporting frameworks are less specific. Depending on these characteristics of the measurement basis applied and on the nature and circumstances of the financial statement item, monetary amounts may need to be estimated. Examples of circumstances when accounting estimates may be required when applying a range of common measurement bases are discussed below.
3. Measurement bases reflect measurement objectives to be applied in determining the required monetary amounts that, by their nature, are generally underpinned by either a historical cost or a current value approach, and either an entity-specific or a market-based perspective of value. The nature of financial statement items also varies widely and gives rise to valuation attributes that would be considered relevant from an entity-specific or a market-based perspective, as applicable. The circumstances relevant to the financial statement items, including general economic, regulatory, technological and market conditions, as well as conditions of more specific relevance to the items, may also give rise to relevant valuation factors.
4. Sometimes, accounting estimates can be made based on values for similar or identical items that are observable in similar circumstances, and that reflect the same measurement basis. In other cases, accounting estimates may be made by modelling a value for the item, based on those attributes that would influence the value of the item in the relevant circumstances (valuation attributes), taking into account:
 - The objectives of the measurement basis; and
 - The nature and circumstances of the item.
5. Modelling an accounting estimate may therefore involve determining:
 - The relevant quantitative and qualitative valuation attributes;
 - To the extent relevant attributes are observable, the sources of data that would be appropriate values for those attributes;
 - To the extent relevant attributes are not observable, the types of assumptions that may represent appropriate values for the relevant attributes and the sources of data that would be appropriate to support those assumptions;

- The method by which such data and assumptions would be used in determining an appropriate value and in developing information about the sensitivity of that value to possible variations in the data and assumptions used; and
- Where applicable, the nature and extent of any adjustments that would may be made to the output from the application of the valuation method, for example to reflect practical limitations of the method not adequately addressed in its conceptual underpinning.

Examples of Circumstances in Which Accounting Estimates May Be Required in Applying Certain Measurement Bases

Historical Cost Measurement Bases

6. Some measurement bases require the use of monetary amounts exchanged or exchangeable for items recorded in the financial statements, in accordance with the terms of transactions that have occurred before the balance sheet date (historical cost). Such amounts may be directly observable (for example, they may be observed in invoices, remittance or payment advices or contract notes or other primary transaction records). When such amounts are not directly observable it may be necessary to estimate the monetary amount that would be exchanged for the item(s). For example, the amounts exchangeable for an item may only be determinable when the outcome of future events or circumstances is known (such as would be the case when part or all of the amount payable for the acquisition of a business depends on the future earnings of the business).

Adjustments and Allocations of Historical Cost Measures

7. Some measurement bases require the use of a historical cost that has been adjusted due to impairment or onerous obligations or that has been allocated between different items or between different periods. The monetary amounts of such adjustments or allocations will often not be directly observable and will need to be estimated.

Impairment

8. The monetary amount of the impairment, if any, of a historical cost measure of an asset at the balance sheet date may not be directly observable, and may depend on future realizations from the use or sale of the item. Even if the impairment of the asset was realized subsequent to the balance sheet date at a monetary amount that was observable, that amount may ~~would~~ not reflect the level of impairment at the balance sheet date, as the level of impairment would have been subject to the effects of changes in circumstances between the balance sheet date and the date of realization.

Depreciation or Amortization

9. The depreciation or amortization of an asset's historical cost during its useful life may only be capable of precise allocation to periods before and after the balance sheet date if, for example, both the extent to which the asset's productive capacity has been consumed through productive use up to that date, and the monetary amount attributable to its residual use, are known with certainty. These amounts may not be determinable with certainty until the asset's total productive use has been observed over its useful life and the residual asset has been disposed of. Ordinarily, therefore, neither of these amounts would be directly

observable when accounting estimates for depreciation or amortization are required to be used for inclusion in the financial statements during the asset's useful life.

Current Value Measurement Bases

10. Some measurement bases require the use of monetary amounts that reflect information about conditions at the measurement date rather than information based on historical transactions. Such bases may require the use of a market-participant or an entity-specific perspective.

Fair Value

11. Some current value measurement bases require the use of a monetary amount that would have been exchanged for the item if a transaction had occurred between market participants in an active market (fair value) and therefore such an amount, by its nature, cannot be observed directly. However, an estimate of such an amount can often be made based on quoted prices for identical items that are observable in an active market accessible to the entity (level 1 fair value).
12. If not, it may be possible to make an estimate of fair value based on observable inputs other than those used in a level 1 fair value, such as quoted prices for similar items in an active market or quoted prices for identical items in a non-active market or other inputs observed in or corroborated with active markets (e.g., interest rates, yield curves, implied volatilities or credit spreads) (level 2 fair value).
13. Otherwise, an estimate of fair value may have to be made, sometimes using discounted cash flow techniques, based on the best information available in the circumstances, including unobservable inputs to the extent observable inputs are not available, and taking into account all information about market participant assumptions that is reasonably available (level 3 fair value).

Value in Use and Fulfilment Value

14. Some measurement bases require the use of monetary amounts that reflect the present value of the future cash flows that the entity will obtain from using and disposing of an asset (value in use) or will incur in fulfilling its obligations inherent in a liability (fulfilment value). The monetary amounts required by such measurement bases cannot be observed directly but may be estimated using discounted cash flow techniques. In principle, value in use and fulfilment value accounting estimates reflect an entity-specific perspective but some attributes used in making them may be required to reflect a market-participant perspective.

Discounted Cash Flow Techniques

15. Measurement bases that involve the use of discounted cash flow techniques in making accounting estimates generally require attributes such as the following to be addressed:
- Estimates of the amount and timing of future cash flows arising from the item;
 - Possible variations in the amount and timing of those cash flows, resulting from uncertainty inherent in those cash flows;
 - Time value of money;

- Price (a risk premium or discount) for bearing the uncertainty inherent in the cash flows; and
- Other attributes, such as liquidity, that would be taken into account in the circumstances.

Appendix 2

(Ref: Para. 3, 10)

Factors That May be Indicators of Risks of Material Misstatements for Accounting Estimates

1. Paragraph 2 of this ISA indicates that accounting estimates may be subject to or affected by complexity, the need for the use of judgment by management and ~~as well as estimation uncertainty~~. The extent to which this is the case affects the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor's responses to those assessed risks. Accordingly, these factors are referred to throughout this ISA and this appendix provides additional background information in relation to them.
2. Paragraphs 3 and 10 of this ISA, respectively, ~~introduces~~ these factors and requires the auditor to take them, and any other relevant factors, into account in the identification and assessment of the risks of material misstatement related to an accounting estimate. In responding to the assessed risks of material misstatement the auditor is required, when the criteria in paragraph 13(b) and 13(c) of this ISA are met, to perform procedures to obtain sufficient appropriate audit evidence about certain matters, when specified circumstances are applicable, related to each of these factors.

Circumstances Where the Three Factors Are Likely To Be More Prevalent

3. As explained in Appendix 1, the nature of the measurement basis applied and the nature and circumstances of the financial statement item will also influence the extent to which these factors are present and need to be taken into account, when applicable, in:
 - (a) Making an accounting estimate of the required monetary amount;
 - (b) Understanding the sensitivity of the accounting estimate to variation in those factors;
and
 - (c) Considering the related disclosures that may be required.
4. Estimates are more likely to be affected by the interrelationship of these three factors, and to a greater extent, when the method involves modelling. Furthermore, the extent to which accounting estimates are subject to or affected by complexity and the need for the use of management judgment is often related closely to the extent to which they are subject to or affected by estimation uncertainty.

Estimation Uncertainty

5. Estimation uncertainty is the inherent uncertainty that makes accounting estimates susceptible to a lack of precision in their measurement. Depending on the nature of the measurement basis applied and on the nature and circumstances of the financial statement item, the required monetary amount of the item may be directly observable before the financial statements are finalized or may only be directly observable at a later date or, in some cases, may not be directly observable at all. Estimation uncertainty arises when the required monetary amount for a financial statement item cannot be obtained by observation before the financial statements are finalized and cannot otherwise be determined with precision.

6. Estimation uncertainty may also give rise to variation in the possible methods, data sources and types of assumptions that could be used to make the accounting estimate and therefore may give rise to the need for the use of judgment in making estimates. This in turn may give rise to variation in the possible outcomes of the estimation process (both in the amount of the accounting estimate and in information developed about the sensitivity of that amount to variations in the data or assumptions used). Such variation is relevant in considering how to depict accounting estimates, in the financial statements, in accordance with the recognition, measurement, presentation and disclosure requirements of the applicable financial reporting framework.
7. There are inherent limitations in information about relevant valuation attributes, and in available data and assumptions that may be used to support values used for the relevant valuation attributes. As a result, although it is possible to reduce estimation uncertainty by applying available information, it is not possible to reduce estimation uncertainty beyond certain limits. Furthermore, most accounting frameworks acknowledge that the information that should be taken into account may also be limited (and that it is therefore not practical to reduce estimation uncertainty beyond this limit) when the cost of obtaining it would exceed the benefits (the cost constraint). Residual estimation uncertainty therefore reflects what is not practically knowable or is not known about these matters.
8. Sources that may influence estimation uncertainty include the volatility in jurisdictions or markets in which the entity is active or the requirements of the applicable financial reporting framework. The extent to which there is residual estimation uncertainty is reflected in the sensitivity of the amount of the accounting estimate to the use of different methods, or to variations in the available data or in the values for the assumptions that could be used, in making the accounting estimate. Although an estimate subject to higher levels of estimation uncertainty may be less precisely measureable than one subject to lower levels, the accounting estimate may still have significant relevance for users of the financial statements if the nature and extent of the estimation uncertainty is appropriately addressed in the financial statements in accordance with the requirements of the applicable financial reporting framework. This is accomplished by appropriately selecting the point estimate to use in the financial statements and appropriately describing the extent, nature and measurement effect of the residual estimation uncertainty. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be recognized in the financial statements, though there may still be relevant disclosure requirements made. As estimation uncertainty cannot be lowered by control testing and performing substantive procedures, the disclosure of the estimation uncertainty in the financial statements is of importance to the users of the financial statements.

Complexity

9. Complexity in making accounting estimates arises when there are multiple valuation attributes and multiple or non-linear relationships between them. Specialized skills or knowledge may, for example, be needed in relation to:
- Available valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques; or to

- Experience of the underlying valuation attributes that may be relevant given the nature and circumstances of the financial statement items for which accounting estimates are being made; –or to
 - The availability of appropriate sources of data (including data relevant to the development of appropriate assumptions) from internal sources (including from sources outside the general or subsidiary ledgers) or from external information sources, or how to address difficulties in obtaining data from such sources or in maintaining its integrity in applying the method.
10. Complexity in applying valuation concepts or techniques; may exist when concepts or techniques involve the use of, for example probability-based methods, option pricing formulae or simulation techniques) to predict uncertain future outcomes or hypothetical behaviors. Complexity in relation to the method may also exist when multiple sources of data, assumptions or valuation concepts or techniques need to be used in determining the output(s) of the estimation process, including when such items need to be interpreted or processed to obtain derived data or to support the development of assumptions.
11. Complexity; in applying valuation concepts or techniques; may also relate to data (including data relevant to the development of appropriate assumptions), including when the data –is inherently difficult to identify, capture, access or understand. For example:-
- (a) Data may be difficult to obtain when it relates to transactions that are not generally transparent to the public at large. Even when such data is accessible through an external information source, it may be difficult to understand unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed.
 - (b) Data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, may be difficult to understand without transparency about the rationale and information taken into account in developing those views.
 - (c) Certain types of data may be inherently difficult to understand because they require an understanding of technically complex business or legal concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products.
- A1E. ~~The extent and nature of complexity originates from the process to make the accounting estimate. The sources that may influence complexity in the process to make the accounting estimate are diverse. For example, complexity may arise from such as the financial reporting framework, and the nature of the entity's business, and the entity's organizational structure. Complexity may also arise from the information systems, methods and models used by management in making the accounting estimate and difficulty in obtaining relevant and reliable data because data is unobservable.~~

Judgment

12. When an accounting estimate is required, the applicable financial reporting frameworks may not fully specify, for each type of financial statement item and in each possible circumstance, the most appropriate approach to make that accounting estimate. It is also generally not practical for the applicable financial reporting framework to specify all the particular valuation attributes, concepts and techniques that should be used to determine the accounting

estimate and related disclosures. As a result, these considerations generally establish a need for the use of judgment by management in making accounting estimates.

13. Judgments are generally also needed to address the inherent information limitations that give rise to estimation uncertainty. In some cases, the level or nature of the inherent limitations in available information may introduce a high degree of subjectivity in making some judgments.
14. The applicable financial reporting framework may provide a basis for making certain such judgments, such as explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgments through requirements for related disclosures.
15. Judgments are generally needed in determining some or all of the following:
 - To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques and attributes to use in the estimation method, having regard to available knowledge;
 - To the extent valuation attributes are observable but there are various potential sources of data available, the appropriate sources of data to use;
 - To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to use, having regard to the limited data available, including, for example, market views;
 - The range of point estimates that could be appropriate to use in the financial statements and the relative likelihood that different parts of the range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework; and
 - The appropriate amount to use for the accounting estimate, and the appropriate related disclosures to be made, in the financial statements.
16. Management may also need to make judgments about cost constraints, including valuation attributes that need to be taken into account but are not directly observable and, about the best information available in the circumstances.
17. Making assumptions about future events or conditions involves the use of judgment, the difficulty of which varies with the extent to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the extent to which those events or conditions are determinable based on available knowledge, including knowledge of past conditions, events and related outcomes. This also contributes to estimation uncertainty, as described above.
18. Not all features of a future outcome may be uncertain and assumptions will only need to be made in respect of those features of the outcome that are uncertain. For example, in considering the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and about the amount and timing of any such loss.

19. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain (for example, the amount of compensation for loss claimed in an ongoing litigation may be highly uncertain). In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment depending on the creditworthiness of the party against whom the claim is made.
20. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.
21. In other cases, it may be necessary to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information from which repeating historical patterns of behavior relating to uncertain valuation attributes may be discerned and extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends). These may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends. Difficult judgments may be needed about the predictive value of such information.
- ~~22A1F. The use of judgment in making accounting estimates is often required by the financial reporting framework due to uncertainties that are present when financial statement items cannot be measured precisely. The extent and nature (including the degree of subjectivity involved) of the judgments used taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the opportunity for management bias and the ability to conceal it may also be increased. The judgments made by management are diverse and include, for example, the selection of assumptions models and data used to make the accounting estimates. The need to remain for professionally skepticism is important when the nature and extent of judgment, complexity and estimation uncertainty is increased.~~

Agenda Item 2-C

INTERNATIONAL STANDARD ON AUDITING 540 AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

Clean

(Effective for audits of financial statements for periods
beginning on or after December 15, [TBA])

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised),¹ ISA 330,² ISA 500³ and other relevant ISAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.

Nature of Accounting Estimates

2. Many financial statement items are susceptible to an inherent lack of precision in their measurement. In the ISAs, such financial statement items are referred to as accounting estimates. Accounting estimates vary widely in nature, and may be subject to, or affected by, complexity, the need for the use of judgment by management, and estimation uncertainty. The extent to which this is the case affects the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor's responses to those assessed risks. (Ref: Para: A1A, Appendix 1, Appendix 2)
3. Accounting estimates may be more susceptible to a risk of material misstatement when:
 - (a) With respect to complexity, management does not:
 - (i) Apply appropriate specialized skills or knowledge in the selection, design or application of the method used to make the accounting estimate, including when the method involves complex modelling;
 - (ii) Appropriately understand the relevance and reliability of the data used, regardless of whether the data is obtained from internal sources or from external information sources; or
 - (iii) Maintain the integrity of the data used.
 - (b) With respect to the need for the use of judgment management does not:
 - (i) Appropriately take into account available information when selecting methods, assumptions, or data; or
 - (ii) Mitigate the risk of management bias; and

¹ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

² ISA 330, *The Auditor's Responses to Assessed Risks*

³ ISA 500, *Audit Evidence*

- (c) With respect to estimation uncertainty, management does not:
 - (i) Take appropriate steps to address estimation uncertainty; or
 - (ii) Select an appropriate management point estimate or make appropriate related disclosures in the financial statements

Key Concepts of This ISA

- 3A. This ISA focuses the auditor's attention on designing and performing further audit procedures (including, where appropriate, tests of controls) responsive to the reasons for the assessment given to the assessed risks of material misstatement, particularly when those reasons include complexity, judgment or estimation uncertainty. This ISA also recognizes that the factors complexity, judgment or estimation uncertainty are interrelated and that there are inherent limitations in reducing estimation uncertainty beyond certain limits.
- 3B. The application of professional skepticism by the auditor is particularly important to the auditor's work relating to accounting estimates. Professional skepticism also is important because there is a particular risk of management bias affecting accounting estimates due to their subjective, potentially complex and uncertain nature, and the possible combined effect of complexity, judgment and estimation uncertainty.
- 4. This ISA requires an overall evaluation of accounting estimates based on the audit procedures performed and the audit evidence obtained. In doing so, the auditor is required to evaluate whether the accounting estimates, and related disclosures, are reasonable. For this purpose, the evaluation of reasonableness involves considerations beyond whether the accounting estimate and related disclosures comply with the requirements of the applicable financial reporting framework. (Ref: Para. A1B–A1C).

Effective Date

- 5. This ISA is effective for audits of financial statements for periods beginning on or after [TBA].

Objective

- 6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:
 - (a) Accounting estimates, whether recognized or disclosed in the financial statements; and
 - (b) Related disclosures in the financial statements,are reasonable in the context of the applicable financial reporting framework.

Definitions

- 7. For purposes of the ISAs, the following terms have the meanings attributed below:
 - (a) Accounting estimate – A monetary amount, prepared in accordance with the requirements of the applicable financial reporting framework, the measurement of which is subject to estimation uncertainty. (Ref: Para. A11A)
 - (b) Auditor's point estimate or auditor's range – An amount, or range of amounts,

respectively, developed by the auditor in evaluating management's point estimate. (Ref: Para. A11B)

- (c) Estimation uncertainty – The susceptibility of an accounting estimate to an inherent lack of precision in its measurement. (Ref: Para. A11C)
- (d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A11D)
- (e) Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.
- (f) Outcome of an accounting estimate – The actual monetary amount that results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para A11E)

Requirements

Risk Assessment Procedures and Related Activities

8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including its internal control, as required by ISA 315 (Revised),⁴ the auditor shall obtain an understanding of the following: (Ref: Para. A12)
 - (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including the recognition criteria, measurement bases and the related presentation and disclosure requirements. (Ref: Para. A13–A15)
 - (aA) Regulatory factors relevant to accounting estimates.⁵ (Ref: Para. A15A–A15C)
 - (aB) The nature of the accounting estimates that the auditor expects to be included in the entity's financial statements. (Ref: Para. A15D–A15E)
 - (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16–A21)
 - (c) How management makes accounting estimates, including: (Ref: Para. A22–A23)
 - (i) The methods used, how they are selected or designed, and how they are applied, including the extent to which they involve complex modelling; (Ref: Para. A23A–A26)
 - (ii) The process used to select assumptions, including alternatives considered and how management identifies significant assumptions; (Ref: Para. A26A–A35D)
 - (iiA) The process used to select data, including the source(s) of that data and how management identifies significant data; (Ref: Para. A35E–A35H)
 - (iii) The extent to which management has applied specialized skills or

⁴ ISA 315 (Revised), paragraphs 5–6 and 11

⁵ ISA 315 (Revised), paragraph 11(a)

knowledge, including whether a management's expert has been used; (Ref: Para. A35I–A35J)

- (iiiA) How the risk of management bias is identified and addressed; (Ref: Para. A35K)
 - (iv) How management has addressed estimation uncertainty; and (Ref: Para. A38)
 - (v) Whether management has addressed the need for a change from the prior period in the methods, assumptions or data used, and if so, the nature of, and reasons for, such changes. (Ref: Para. A38A).
- (d) Each of the components of internal control as they relate to making accounting estimates.⁶ (Ref: Para. A38B–A38P)
9. The auditor shall review the outcome or re-estimation of previous accounting estimates to the extent that doing so will assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question, based on new information, judgments about previous accounting estimates that were appropriate based on the information available at the time. (Ref: Para. A38Q–A44)
- 9A. The auditor shall consider whether specialized skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. (Ref: Para. A44A–A44E)

Identifying and Assessing the Risks of Material Misstatement

10. In applying ISA 315 (Revised), the auditor is required to identify and assess the risks of material misstatement, at the financial statement and assertion levels, and to determine whether any of the risks of material misstatement identified are, in the auditor's judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate, the auditor shall take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including: (Ref: Para. A44F–A44M)
- (a) Complexity in making the accounting estimate, including:
 - (i) The extent to which the method used by management involves specialized skills or knowledge, including with respect to the use of a model; and (Ref: Para. A44N–A44P)
 - (ii) The difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data; (Ref: Para. A44Q)
 - (b) The need for the use of judgment by management and the potential for management bias, including with respect to methods, assumptions, and data; and (Ref: Para. A44R–A44T)
 - (c) Estimation uncertainty, including the extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the assumptions

⁶ ISA 315 (Revised), paragraphs 14–24

and data used. (Ref: Para. A44U–A49C)

Responses to the Assessed Risks of Material Misstatement

- 11A. In responding to the assessed risks of material misstatement related to accounting estimates, the auditor shall consider whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures. (Ref: Para. A44A–A44F)
13. In applying ISA 330, the auditor is required to design and perform further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. In doing so, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that relevant controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. With respect to accounting estimates: (Ref: Para. A57A–A57G)
- (a) If the assessed risk of material misstatement is low, but not because that assessment includes an expectation that relevant controls are operating effectively, the auditor shall consider whether a procedure(s) that addresses management's point estimate at an overall level would provide sufficient appropriate audit evidence regarding the assessed risk of material misstatement in the circumstances. (Ref: Para. A57H)
 - (b) If the assessed risk of material misstatement is low and that assessment includes an expectation that relevant controls are operating effectively, the auditor's further audit procedures shall include tests of controls to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable. Such procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10. (Ref: Para. A57I)
 - (c) If the assessed risk of material misstatement is not low, the auditor's further audit procedures shall include procedures to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable. Such procedures (whether substantive procedures or tests of controls) shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needs to be. (Ref: Para. A57J–A57L)

Complexity

- 13A. In complying with paragraphs 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include complexity, the auditor shall obtain sufficient appropriate audit evidence about the following matters when management uses a complex method (including complex modelling), or when management's method otherwise involves the use of specialized skills or knowledge: (Ref: Para A59A–A59D)
- (a) Whether the method, and significant data and assumptions, are appropriate in the context of the applicable financial reporting framework;

- (b) Whether significant data is relevant and reliable.⁷
- (c) Whether management has appropriately understood or interpreted significant data, including with respect to contractual terms. (Ref: Para. A59E)
- (d) Whether the integrity of significant data and assumptions has been maintained in applying the method; and (Ref: Para. A59F)
- (e) Whether the calculations are mathematically accurate and are appropriately applied

Judgment

13B. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include the need for the use of judgment by management, the auditor shall obtain sufficient appropriate audit evidence about the following matters:

- (a) When the accounting estimate involves the use of significant data or assumptions:
 - (i) Whether management's judgments regarding the selection of the method and the significant data and assumptions: (Ref: Para A59G)
 - a. Are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework; or
 - b. Give rise to indicators of possible management bias;
 - (ii) Whether management's judgments about changes from previous periods in the method or the significant data or assumptions, are appropriate (Ref: Para. A59H–A59L);
 - (iii) Whether significant assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities.;
 - (iv) Whether management's judgments in applying the requirements of the applicable financial reporting framework are appropriate;
- (b) When relevant to the appropriateness of the significant assumptions or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so (Ref: Para. A59M);
- (c) When management's application of the method involves complex modelling, whether judgments made have been applied consistently and whether, when applicable:
 - (i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;
 - (ii) Changes, if any, from the previous period's model are appropriate in the circumstances; and

⁷ ISA 500, paragraph 7

- (iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework. (Ref: Para A59N)

Estimation Uncertainty

13C. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor shall obtain sufficient appropriate audit evidence about the following matters:

- (a) Whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to: (Ref: Para. A59O)
 - (i) Understand and address the estimation uncertainty, and develop a point estimate that meets the measurement objective of the applicable financial reporting framework; and
 - (ii) Whether:
 - (a) Management's point estimate is reasonable; and
 - (b) The disclosures in the financial statements that describe the estimation uncertainty are reasonable. (Ref: Para. A60A–A60B)
- (b) When, in the auditor's judgment, management has not appropriately addressed the effect of estimation uncertainty, based on the audit evidence obtained, the auditor shall, to the extent possible, develop an auditor's point estimate or range to enable the auditor to evaluate the reasonableness of management's point estimate and the disclosures in the financial statements that describe the estimation uncertainty. (Ref: Para A60C–A60K)
- (c) If, based on the audit evidence obtained, the auditor concludes that it is not appropriate to determine an auditor's point estimate, but that it is appropriate to develop an auditor's range, the auditor shall only include in that range amounts that: (Ref: Para A60L–A60M)
 - (i) Are supported by the audit evidence; and
 - (ii) The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.

Disclosures Related to Accounting Estimates

13D. The auditor shall obtain sufficient appropriate audit evidence to evaluate whether the accounting estimates have been appropriately disclosed in accordance with the requirements of the applicable financial reporting framework and: (Ref: Para. A120–A121A)

- (a) In the case of a fair presentation framework, shall evaluate whether it is necessary for management to provide disclosures beyond those specifically required by the framework to achieve the fair presentation of the financial statements as a whole, or
- (b) In the case of a compliance framework, shall evaluate whether the disclosures are appropriate for the financial statements not to be misleading.

Overall Evaluation Based on Audit Procedures Performed

- 13E. In applying ISA 330⁸ to the accounting estimates for which the auditor's further audit procedures address the matters in paragraphs 13A–13C, the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A121B–A121D)
- (a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified; and
 - (b) Sufficient appropriate audit evidence has been obtained; and
 - (c) Management's decisions 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.
- 13F. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. In making this evaluation, the auditor shall consider all relevant audit evidence obtained whether corroborative or contradictory. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit.⁹ (Ref: Para. A1B–A1C, A121E–A121H)

Indicators of Possible Management Bias

21. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate possible bias on the part of the entity's management. When indicators of possible bias are identified the auditor shall evaluate the implications for the audit. (Ref: Para. A121I–A121N)

Written Representations

22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that they believe the methods and significant data and assumptions used in making the accounting estimates and their related disclosures are appropriate. The auditor shall also consider the need to obtain representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A126–A127)

Communication with Those Charged With Governance or Management

- 22A. In applying ISA 260 (Revised)¹⁰ and ISA 265,¹¹ the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant

⁸ ISA 330, paragraphs 25 and 26

⁹ ISA 330, paragraph 27

¹⁰ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 16(a)

¹¹ ISA 265, *Communicating Deficiencies in Internal Control To Those Charged With Governance And Management* paragraph 9

deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate related to the extent to which the accounting estimates and their related disclosures are affected by, or subject to, estimation uncertainty, complexity, use of judgment by management, or other relevant factors. (Ref: Para. A127A–A127C)

Documentation

23. The audit documentation shall include:

- (a) The basis for the auditor's evaluation of the reasonableness of the accounting estimates and related disclosures; and
- (b) Indicators of possible management bias, if any, and the auditor's evaluation thereof in forming the auditor's opinion on whether the financial statements as a whole are materially misstated. (Ref: Para. A128)

* * *

Application and Other Explanatory Material

Nature of Accounting Estimates (Ref: Para. 2)

A1A. Examples of situations where accounting estimates may be required include:

- Inventory obsolescence.
- Warranty obligations.
- Depreciation method.
- Outcome of long term contracts.
- Estimated costs arising from litigation settlements and judgments.
- Expected credit losses.
- Valuation of insurance contract liabilities.
- Valuation of complex financial instruments, including those that are not traded in an active market.
- Share-based payments.
- Assets or liabilities acquired in a business combination, including goodwill and intangible assets.
- Property or equipment held for disposal.
- Transactions involving the exchange of assets or liabilities between independent parties without monetary consideration, for example, a non-monetary exchange of plant facilities in different lines of business.

Key Concepts (Ref: Para. 2, 13-F)

A1B. The auditor is required to obtain sufficient appropriate audit evidence about whether the accounting estimates recognized or disclosed, are reasonable. What is reasonable

depends on the facts and circumstances in the context of the applicable financial reporting framework.

A1C. The following factors may be relevant to the auditor's evaluation of whether the accounting estimate and related disclosures are reasonable:¹²

- The accounting estimate and related disclosures meet the requirements of the applicable financial reporting framework;
- The accounting estimate takes into account appropriate information available at the time of issuance of the auditor's report; and
- In the context of the applicable financial reporting framework and in view of the nature of the estimate and the facts and circumstances of the entity:
 - The method, assumptions and data (including related judgments) are appropriate;
 - The accounting estimate and its data and assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities; and
 - The disclosures are appropriate, including disclosures regarding estimation uncertainty.

Definitions

Accounting Estimate (Ref: Para. 7(a))

A11A. Accounting estimates are monetary amounts that may be classes of transactions or account balances recognized in the financial statements, but also include accounting estimates used in disclosures or used to make judgments about whether or not to recognize or disclose a monetary amount.

Auditor's Point Estimate or Auditor's Range (Ref: Para. 7(b))

A11B. An auditor's point estimate or a range may be developed for an accounting estimate as a whole (for example, the expected credit losses for a particular loan portfolio or the fair value of different types of financial instruments), or a component of an accounting estimate (for example, an amount to be used as a significant assumption or data for an accounting estimate). A similar approach may be taken by the auditor in developing an amount or range of amounts in evaluating an item of data or an assumption (for example, an estimated useful life of an asset).

Estimation Uncertainty (Ref: Para. 7(c))

A11C. Estimation uncertainty is an inherent characteristic of accounting estimates. The measurement effect of estimation uncertainty can be reduced by using appropriate available information sources. However, limitations in the availability of relevant information and in the practicality of using available information (e.g., when the cost of obtaining it exceeds the benefit of using it), mean that estimation uncertainty cannot be reduced beyond a certain level (in other words, residual estimation uncertainty). The nature and implications of estimation uncertainty are discussed further in Appendix B.

¹² See also ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, paragraph 13(c).

Management Bias (Ref: Para. 7(e))

A11D. Financial reporting frameworks often call for neutrality, that is, freedom from bias. The inherent lack of imprecision in the measurement of accounting estimates gives rise to the need for the use of judgment by management. Such judgment may be influenced by unintentional or intentional management bias (for example, as a result of motivation to achieve a desired profit target or capital ratio). The susceptibility of an accounting estimate to management bias increases with the extent to which there is a need for judgment in making it. Unintentional management bias and the potential for intentional management bias are inherent in subjective decisions that are often required in making an accounting estimate. For continuing audits, indicators of possible management bias identified during the audit of the preceding periods influence the planning and risk identification and assessment activities of the auditor in the current period.

Outcome of an Accounting Estimate (Ref: Para. 7(f))

A11E. Some accounting estimates, by their nature, do not have an outcome that is relevant for the auditor's work performed in accordance with this ISA. For example, an accounting estimate may be based on perceptions of market participants at a point in time. Accordingly, the price realized when an asset is sold or the liability transferred may differ from the accounting estimate at the reporting date because, with the passage of time, the market participants' perceptions of value may change.

Risk Assessment Procedures and Related Activities (Ref: Para. 8)

A12. The risk assessment procedures and related activities required by paragraph 8 of this ISA assist the auditor in obtaining an understanding of the nature of the accounting estimates and related disclosures that an entity may be expected to include in its financial statements and of the entity's internal control relevant to making its accounting estimates. In relation to the entity's accounting estimates, the auditor's primary consideration is whether that understanding is sufficient to:

- Identify and assess the risks of material misstatement, including determining whether, in the auditor's judgment, any of those risks are significant risks; and
- Plan the nature, timing and extent of further audit procedures.

Obtaining an Understanding of the Requirements of the Applicable Financial Reporting Framework (Ref: Para. 8(a))

A13. Obtaining an understanding of the requirements of the applicable financial reporting framework provides the auditor with a basis for discussion with management and those charged with governance about how management has applied those requirements relevant to the accounting estimates, and about the auditor's determination of whether they have been applied appropriately. This understanding also may assist the auditor in communicating with those charged with governance when the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate in the circumstances of the entity.¹³

A14. For certain accounting estimates, financial reporting frameworks may prescribe or

¹³ ISA 260 (Revised), paragraph 16(a)

provide guidance on the basis for selecting management's point estimate, which may be, for example, the most likely outcome¹⁴ or a discounted probability-weighted expected value. Depending on the circumstances, it may be possible for the accounting estimate to be determined directly, or it may be possible to select a management point estimate only after considering alternative assumptions or the range of possible measurement outcomes.

- A15. Financial reporting frameworks may specify criteria for, or guidance on, the disclosure of information concerning judgments, assumptions, or other sources of estimation uncertainty relating to accounting estimates.

Obtaining an Understanding of Regulatory Factors (Ref: Para. 8(aA))

A15A. Obtaining an understanding of the relevant aspects of the regulatory framework (e.g., regulation established by banking and insurance regulators) may assist the auditor in determining whether, for example, the regulatory framework:

- Addresses conditions for the recognition, or methods for the measurement, of accounting estimates, or provides related guidance thereon;
- Specifies, or provides guidance about, disclosures in addition to the requirements of the applicable financial reporting framework; or
- Provides an indication of areas for which there may be a potential for management bias to meet regulatory requirements.

A15B. Obtaining such an understanding may also highlight requirements for regulatory purposes that are not consistent with requirements of the applicable financial reporting purposes, which may indicate potential risks of material misstatement. For example, the measurement basis for certain financial statement items, for regulatory capital maintenance purposes, may require earlier recognition of losses than the measurement basis, in accordance with the applicable financial reporting framework, for an accounting estimate relating to the item.

A15C. ISA 250 (Revised) includes requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates, including regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements.¹⁵

Obtaining an Understanding of the Nature of the Accounting Estimates That the Auditor Expects to be included in the Financial Statements (Ref: Para. 8(aB))

A15D. Obtaining an understanding of the accounting estimates and related disclosures that the auditor expects to be included in the financial statements assists the auditor in understanding the measurement basis and the nature and extent of disclosures that may be relevant. Such an understanding provides the auditor with a basis for discussion with management about how management has made the accounting estimates. The auditor may obtain an understanding of the accounting estimates that the auditor expects to be

¹⁴ Different financial reporting frameworks may use different terminology to describe point estimates determined in this way.

¹⁵ ISA 250 (Revised), *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraphs 12 and A7

included in the financial statements through the auditor's:

- Understanding of the nature of the entity, including the nature of the assets and liabilities and other financial statement items that it would be expected to have, given the nature of its operations, ownership and governance structures and investments, the way it is structured and financed, its objectives and strategies and related business risks;
- Understanding of the applicable financial reporting framework, and other relevant legal, regulatory and other external factors;
- Past knowledge and experience, including that obtained through other audits; and
- Previous experience with the entity.¹⁶

A15E. Developing an expectation of the nature of the accounting estimates and related disclosures may also assist the auditor in understanding whether the accounting estimates are complex to make, require significant judgment by management, or have high estimation uncertainty.

Obtaining an Understanding of How Management Identifies the Need for the Accounting Estimates (Ref: Para. 8(b))

A16. The preparation of the financial statements requires management to determine whether a transaction, event or condition gives rise to the need to make an accounting estimate, and that all necessary accounting estimates have been recognized, measured, presented, and disclosed in the financial statements, in accordance with the applicable financial reporting framework.

A17. Management's identification of transactions, events and conditions that give rise to the need for accounting estimates is likely to be based on:

- Management's knowledge of the entity's business and the industry in which it operates.
- Management's knowledge of the implementation of business strategies in the current period.
- Where applicable, management's cumulative experience of preparing the entity's financial statements in previous periods.

The auditor may obtain an understanding of how management identifies the need for accounting estimates primarily through inquiry of management. Management may periodically review the circumstances that give rise to the need for accounting estimates and for re-estimating them as necessary. Further, management may have established a risk assessment process in this area which may involve a formal risk management or similar function. In such circumstances, the auditor's risk assessment procedures may be directed at understanding such a review or risk assessment processes. How management addresses the completeness of accounting estimates, particularly estimates related to liabilities, is often an important consideration of the auditor.

A18. The auditor's understanding of the entity and its environment obtained during the performance of risk assessment procedures, together with other audit evidence obtained

¹⁶ ISA 315 (Revised), paragraph 9

during the course of the audit, assists the auditor in identifying circumstances, or changes in circumstances, that may give rise to the need for accounting estimates.

A19. Inquiries of management about changes in circumstances may include, for example, inquiries about whether:

- The entity has engaged in new types of transactions that may give rise to accounting estimates.
- Terms of transactions that gave rise to accounting estimates have changed.
- Accounting policies relating to accounting estimates have changed, as a result of changes to the requirements of the applicable financial reporting framework or otherwise.
- Regulatory or other changes outside the control of management have occurred that may require management to revise, or make new, accounting estimates.
- New conditions or events have occurred that may give rise to the need for new or revised accounting estimates.

A20. During the audit, the auditor may identify transactions, events and conditions that give rise to the need for accounting estimates that management failed to identify. ISA 315 (Revised) deals with circumstances where the auditor identifies risks of material misstatement that management failed to identify, including determining whether there is a significant deficiency in internal control with regard to the entity's risk assessment processes.¹⁷

Considerations Specific to Smaller Entities

A21. Obtaining this understanding for smaller entities is often less complex as their business activities are often more limited and their transactions are often less complex. Further, often a single person, for example the owner-manager, identifies the need to make the accounting estimates and the auditor's inquiries may be focused accordingly.

Obtaining an Understanding of How Management Makes Accounting Estimates (Ref: Para. 8(c))

A22. The preparation of the financial statements also requires management to establish financial reporting processes for making accounting estimates, including adequate internal control. Such processes include the following:

- Selecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods, including, where applicable, models.
- Developing or identifying relevant data and assumptions that are used in making accounting estimates.
- Periodically reviewing the circumstances that give rise to the accounting estimates and re-estimating as necessary.

A23. Matters that the auditor may consider in obtaining an understanding of how management makes the accounting estimates include, for example:

¹⁷ ISA 315 (Revised), paragraph 16

- The types of accounts or classes of transactions to which the accounting estimate relate (for example, whether the accounting estimates arise from the recording of routine and recurring transactions or whether they arise from non-recurring or unusual transactions).
- Whether and, if so, how management has used recognized measurement techniques for making particular accounting estimates.
- Whether the accounting estimates were made based on data available at an interim date and, if so, whether and how management has taken into account the effect of events, transactions and changes in circumstances occurring between that date and the period end.

Methods (Ref: Para. 8(c)(i))

A23A. A method is a measurement technique used by management to apply the measurement basis in the financial reporting framework. In some cases, the applicable financial reporting framework may prescribe the method to be used for making an accounting estimate. In many cases, however, the applicable financial reporting framework does not prescribe a single method or the required measurement basis prescribes, or allows, the use of alternative methods.

A23B. For example, one recognized method used to make accounting estimates relating to share based payment transactions is to determine a theoretical option call price using the Black Scholes option pricing formula. This method may be applied by modelling the data and assumptions of that formula based on the terms of the transaction and market conditions relevant to the underlying share.

A23C. A model is a tool used to make the accounting estimate that applies assumptions and data, and a set of relationships between them as specified by the method.

A23D. A model is complex when:

- The method it applies requires more specialized skills or knowledge;
- It is more difficult to obtain relevant and reliable data needed for use in the model;
- It is difficult to maintain the integrity of that data;
- It exhibits a significant degree of complexity in its design or operation, which may, for example, involve more extensive use of information technology or large volumes of data; or
- It uses multiple data sources or assumptions with complex-interrelationships.

A25A. Management may design and implement specific controls around models used for making accounting estimates, whether management's own model or an external model. Controls that address complexity around models are more likely to be relevant to the audit when the model used is complex, such as an expected credit loss model or a model used for the valuation of insurance contract liabilities. Factors that may be appropriate for the auditor to consider in obtaining an understanding of the model and of related control activities, include the following:

- How management determines the relevance and accuracy of the model;
- The validation or back testing of the model, including whether the model is

validated prior to use and revalidated at regular intervals to determine whether it remains suitable for its intended use. The entity's validation of the model may include evaluation of:

- The model's theoretical soundness;
 - The model's mathematical integrity;
 - The accuracy and completeness of the data and assumptions used in the model; and
 - Whether the appropriate data is used in the model and appropriate assumptions have been made;
- How the model is appropriately changed or adjusted on a timely basis for changes in market or other conditions and whether there are appropriate change control policies over the model;
 - Whether adjustments, also referred to as overlays in certain industries, are made to the output of the model and whether such adjustments are appropriate under the circumstances and consistent with the requirements of the applicable financial reporting framework; and
 - Whether the model is adequately documented, including its intended applications, limitations, key parameters, required data and assumptions, the results of any validation performed on it and the nature of, and basis for, any adjustments made to its output.

A26. There may be greater susceptibility to risks of material misstatement relating to the use of models, for example, in cases when management has developed a model internally but has relatively little experience in doing so, or uses a model that applies a method that is not established or commonly used in a particular industry or environment.

Assumptions Ref: Para. 8(c)(ii))

A26A. Assumptions are integral components of accounting estimates and may include matters such as the choice of an interest rate, a discount rate, or judgments about future conditions or events. An assumption may be selected by management from a range of possible alternatives for use in applying a method to make accounting estimates.

A31. Matters that the auditor may consider in obtaining an understanding of the assumptions used in making the accounting estimates include, for example:

- The nature of the assumptions used, the alternatives considered and the basis for management's selection. The applicable financial reporting framework may provide criteria or guidance to be used in the selection of an assumption.
- How management assesses whether the assumptions are relevant and complete.
- When applicable, how management determines that the assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity's business activities.
- How the assumptions are consistent with other matters:
 - Within the control of management (for example, assumptions about the maintenance programs that may affect the estimation of an asset's useful life),

and whether they are consistent with the entity's business plans and the external environment; and

- Outside the control of management (for example, assumptions about interest rates, mortality rates, potential judicial or regulatory actions, or the variability and the timing of future cash flows).
- Management's documentation supporting the assumptions.
- The disclosures of assumptions required by the applicable financial reporting framework.
- How management identifies significant assumptions.

Assumptions may be made or identified by a management's expert to assist management in making the accounting estimates. Such assumptions, when used by management, become management's assumptions.

A35. With respect to fair value accounting estimates, assumptions vary in terms of the sources of the data and the basis for the judgments to support them, as follows:

- (a) Those that reflect what marketplace participants would use in pricing an asset or liability developed based on market data obtained from sources independent of the reporting entity.
- (b) Those that reflect the entity's own judgments about what assumptions marketplace participants would use in pricing the asset or liability developed based on the best data available in the circumstances.

In practice, however, the distinction between (a) and (b) may not always be apparent and distinguishing between them depends on understanding the sources of data and the basis for the judgments that support the assumption. Further, it may be necessary for management to select from a number of different assumptions used by different marketplace participants.

Significant data and assumptions

A35A. Data and assumptions used in making an accounting estimate are referred to as significant data or significant assumptions in this ISA if a reasonable variation in the data or assumption would materially affect the measurement of the accounting estimate. For example, an accounting estimate may be determined applying a method that uses several data sets and several assumptions, one or more of which particularly influences the measurement of the accounting estimate because the range of reasonable assumptions may be large or the model may be sensitive to specific data or assumption because of the underlying formulas.

Inactive or illiquid markets

A35B. Some financial reporting frameworks require different accounting treatments depending on the level of activity in the market. Estimation uncertainty increases and valuation is more complex when the markets in which financial instruments or their component parts are traded become inactive. Valuation techniques selected in times when market information was available may not provide appropriate valuations in times of stress. However, even where markets are inactive, prices achieved may still provide relevant evidence about fair value. In these circumstances, valuations may be developed based

on more unobservable inputs, requiring more judgment by management. When markets are inactive, prices quoted may not represent prices at which market participants would trade or may represent forced transactions (such as when disposal of an asset is necessary to meet regulatory or legal requirements).

A35C. Particular difficulties may develop where there is severe curtailment or even cessation of trading in particular financial instruments. In these circumstances, financial instruments that have previously been valued using market prices may need to be valued using a model; or, where they have previously been valued using a model, the model may need to change. Reacting to changes in market conditions may be difficult if management does not possess the specialized skills or knowledge necessary to develop an appropriate model on a timely basis, or to select the valuation technique that may be most appropriate in the circumstances.

A35D. When markets are inactive or illiquid, the auditor's understanding of how management selects assumptions may include understanding whether management has:

- Implemented appropriate policies for adapting the application of the method in such circumstances. Such adaptation may include making model adjustments or developing new models that are appropriate in the circumstances;
- Resources with the necessary skills or knowledge to adapt or develop a model, if necessary on an urgent basis, including selecting the valuation technique that is appropriate, in such circumstances;
- The resources to calculate the range of outcomes, given the uncertainties involved, for example by performing a sensitivity analysis;
- The means to assess how, when applicable, the deterioration in market conditions has affected the entity's operations, environment and relevant business risks and the implications for the entity's accounting estimates, in such circumstances; and
- An appropriate understanding of how the price data from particular external information sources may vary in such circumstances.

Data (Ref: Para. 8(c)(iiA))

A35E. Data comprises factual data, which can be observed directly, and derived data, which is data obtained through applying analytical or interpretive techniques to factual data. The analytical or interpretive techniques to be used in deriving data have a well-established theoretical basis and do not involve the application of judgment. Examples of data include:

- Prices agreed in market transactions;
- Operating times or quantities of output from a production machine;
- Historical prices or other terms included in contracts (for example, a loan agreement may include a contracted interest rate, a payment schedule, and term of the loan); or
- Forward looking data such as economic or earnings forecasts made publicly, or a future payment schedule in a loan agreement.

A35F. Data can come from a wide range of sources. For example, data can be:

- generated within the organization or externally;

- Obtained from a system that is either within or outside the general or subsidiary ledgers;
- Observable in contracts; and
- Observable in legislative or regulatory pronouncements.

Understanding the source of the data used to make the accounting estimates may help the auditor in understanding the risks with respect to the relevance and reliability of the data.

A35G. Matters that the auditor may consider in obtaining an understanding of the data on which the accounting estimates are based include:

- The nature of the data.
- How management evaluates whether the data is appropriate.
- The accuracy and completeness of the data.
- The consistency of the data used with data used in previous periods.
- The complexity of the information technology systems used to obtain and process the data, including when this involves handling large volumes of data.
- How the data is obtained, transmitted and processed and how its integrity is maintained.

A35H. When making an accounting estimate involves large volumes of data or otherwise involves complex processing, management may make extensive use of information technology. In such cases, it may be necessary for the auditor to understand and test information technology general controls and relevant application controls. Such controls address risks related to:

- The complete and accurate extraction of data from the entity's records or from external information sources; and
- The complete and accurate flow of data through the entity's information systems and the appropriateness of any modification to the data used in making accounting estimates, such as the translation of data into a different currency. Controls to maintain the integrity and security of the data are important.

Management's Application of Specialized Skills or Knowledge, Including the Use of Management's Experts (Ref: Para. 8(c)(iii))

A35I. Management may have, or the entity may employ individuals with, the skills and knowledge necessary to make the accounting estimates. In some cases, however, management may need to engage an expert to make, or assist in making, them. This need may arise because of, for example:

- The specialized nature of the matter requiring estimation, for example, the accounting estimate may involve measurement of mineral or hydrocarbon reserves in extractive industries or the evaluation of the likely outcome of applying complex contractual terms.
- The complex nature of the models required to apply the relevant requirements of the applicable financial reporting framework, as may be the case in certain

measurements, such as level 3 fair values.

- The unusual or infrequent nature of the condition, transaction or event requiring an accounting estimate.

A failure by management to apply the required specialized skills or knowledge, including engaging an expert when management does not otherwise have access to an individual with such skills and knowledge, increases control risk.

Considerations specific to smaller entities

A35J. In smaller entities, the circumstances requiring accounting estimates often are such that the owner-manager is capable of making the required point estimate. In some cases, however, an expert will be needed. Discussion with the owner-manager early in the audit process about the nature of any accounting estimates, the completeness of the required accounting estimates, and the adequacy of the estimating process may assist the owner-manager in determining the need to use an expert.

Risk of Management Bias (Ref: Para. 8(c)(iB))

A35K. Matters that the auditor may consider in obtaining an understanding of how management addresses the risk of management bias in making accounting estimates includes whether, and if so how management:

- Identifies and pays particular attention to accounting estimates that involve greater levels of subjectivity in related judgments.
- Monitors key performance indicators that may indicate unexpected or inconsistent performance compared with historical or budgeted performance or with other known factors.
- Identifies financial or other incentives that may be a motivation for bias.
- Monitors changes in the methods, or in significant sources of data and significant assumptions, used in making accounting estimates.
- Establishes appropriate oversight and review of models used in making accounting estimates.
- Requires documentation of the rationale for, or an independent review of, significant judgments made in making accounting estimates.

Estimation Uncertainty (Ref: Para. 8(c)(iv))

A38. Matters that may be appropriate for the auditor to consider in obtaining an understanding of whether and, if so, how management has addressed estimation uncertainty include, for example:

- Whether and, if so, how management has identified alternative methods, significant assumptions or sources of significant data that are appropriate in the context of the applicable financial reporting framework.
- Whether and, if so, how management has considered alternative outcomes by, for example, performing a sensitivity analysis to determine the effect of changes in the data or assumptions on the accounting estimate.
- How management determines its point estimate when analysis indicates a number

of possible outcome scenarios.

- Whether management monitors the outcome of accounting estimates made in previous periods, and how management has appropriately responded to the results of that monitoring.

Changes in Methods, Assumptions or Data Used in Making Accounting Estimates (Ref: Para. 8(c)(vi))

A38A. In evaluating how management makes the accounting estimates, the auditor is required to understand the extent to which management has identified and addressed the need for change in the methods, assumptions or data used in making the accounting estimates. If management has changed the method for making an accounting estimate, it is important that management can demonstrate that the new method is more appropriate, or is itself a response to changes in the environment or circumstances affecting the entity, or to changes in the requirements of the applicable financial reporting framework or regulatory environment. It is also important that management can demonstrate, when no change has been made, that the continued use of the previous methods, assumptions and data is appropriate in view of the current environment or circumstances. For example, whether management's assumptions about marketplace transactions or price quotes reflect fair value when there is reduced market activity.

Components of Internal Control Relating To Accounting Estimates (Ref: Para. 8(d))

A38B. Paragraphs 14–24 of ISA 315 (Revised) describe the components of internal control and provide useful information for the auditor in considering the components of internal control as they relate to making accounting estimates.

A38C. Some entities may have a wide range of accounting estimates, some of which may be significantly affected by, or subject to, complexity, the need for use of judgment by management, and estimation uncertainty. In such circumstances, there may be an increased need for the application of specialized skills or knowledge, and management may make extensive use of information technology in making the estimates. In such cases, it likely will be more important for the auditor to understand of the design and implementation, and test the operating effectiveness, of related controls. It is likely to be less important for entities that may not have many, or any, estimates that exhibit such characteristics.

The Control Environment Relevant To Making Accounting Estimates

A38D. The auditor's understanding of the control environment relevant to making accounting estimates includes consideration of the influence that the elements of the control environment would be expected to have on the risks of material misstatement.¹⁸ This may include, for example, whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of transparency and proper ethical behavior, as it relates to making the accounting estimates; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, insofar as they

¹⁸ ISA 315 (Revised), paragraph A77

relate to the accounting estimates, and whether those other components are not undermined by deficiencies in the control environment.

A38E. In some industries, such as the banking or insurance industry, the term governance may be used to describe the control environment as described in ISA 315 (Revised).¹⁹

Oversight by those charged with governance

A38F. Management and, where applicable, those charged with governance are responsible for designing and implementing a system of internal control to enable the preparation of financial statements in accordance with the applicable financial reporting framework. The effectiveness of the design of the control environment in relation to participation by those charged with governance is influenced by the matters described in paragraph A80 in ISA 315 (Revised).

A38G. How effective those charged with governance are in overseeing the control environment set by management, with respect to accounting estimates, may be influenced by such matters as the extent to which they:

- Have the skills or knowledge to understand the characteristics of a particular method or model to make accounting estimates, or the risks related to the accounting estimate, for example, risks related to the method or information technology used in making the accounting estimates;
- Have the skills and knowledge to understand whether management made the accounting estimates in accordance with the applicable financial reporting framework; or
- Are independent from management, have the information required to evaluate on a timely basis how management made the accounting estimates, and the authority to challenge management when those actions appear to be inadequate or inappropriate.

A38H. Depending on the nature of the accounting estimates, the auditor may consider obtaining an understanding of the oversight by those charged with governance over matters, such as:

- Management's process for making the accounting estimates, including the use of models.
- The monitoring activities undertaken by management. This may include appropriate supervision and review of the accounting estimates designed to detect and correct any deficiencies in the operating effectiveness of controls over the accounting estimates.

A38I. The oversight by those charged with governance may particularly be important for accounting estimates that:

- Require significant judgment by management, for example in the selection of the method, significant assumptions or significant data;
- Have high estimation uncertainty;
- Are complex to make, for example, because of the extensive use of information

¹⁹ ISA 315 (Revised) paragraph A76

technology, large volumes of data or the use of multiple data sources or assumptions with complex-interrelationships;

- Had, or ought to have had, a change in the method, assumptions or data compared to previous periods; or
- Involve significant data and assumptions.

The Entity's Risk Assessment Process

A38J. If the entity has a risk assessment process, the auditor needs to obtain an understanding of the process and its results in relation to the entity's accounting estimates, including how management determines the risks to be managed arising from changes in:

- The requirements of the applicable financial reporting framework related to the accounting estimates;
- The availability or nature of data sources that are relevant to making the accounting estimates or that may affect the reliability of the data used;
- The entity's information systems or IT environment; and
- Key personnel.

The Entity's Information Systems

A38K. With respect to the entity's information system relevant to making accounting estimates, it may be appropriate for the auditor to obtain an understanding as to whether:

- The information systems have the capability and are appropriately configured to process large volumes of data;
- When diverse systems are required to process complex transactions, regular reconciliations between the systems are made, in particular when the systems do not have automated interfaces or may be subject to manual intervention;
- The design and calibration of complex models is periodically evaluated;
- Management has controls around access, change and maintenance of individual models to maintain a strong audit trail of the accredited versions of models and to prevent unauthorized access or amendments to those models;
- When using external information sources, management considers and appropriately addresses the risks related to processing or recording the data, recognizing management's responsibility for appropriately reconciling and challenging the data from those sources; and
- There are appropriate controls over the transfer of information relating to accounting estimates into the general ledger, including appropriate controls over related journal entries.

A38L. Information systems relevant to financial reporting are an important source for the quantitative and qualitative disclosures in the financial statements. This may include a system developed and maintained by the entity primarily for internal reporting, but which also captures, processes and generates data that may be included in disclosures relating to accounting estimates.

Control Activities

A38M. The auditor needs to obtain an understanding of the control activities relevant to the audit as they relate to accounting estimates and the auditor's consideration of such control activities may be more important when the accounting estimates are significantly subject to, or affected by, complexity, the use of judgment by management, or estimation uncertainty. This may include control activities related to:

- How management determines the relevance and reliability of the data used to develop the accounting estimates, including when management uses an external information source or data from outside the general and subsidiary ledgers.
- The review and approval of accounting estimates, including the assumptions or data used in their development, by appropriate levels of management and, where appropriate, those charged with governance.
- The segregation of duties between those committing the entity to the underlying transactions and those responsible for making the accounting estimates, including whether the assignment of responsibilities appropriately takes account of the nature of the entity and its products or services. For example, in the case of a large financial institution, relevant segregation of duties may consist of an independent function responsible for estimation and validation of fair value pricing of the entity's financial products staffed by individuals whose remuneration is not tied to such products.
- The control activities included in paragraph A25A.

The Entity's Activities to Monitor Controls over How the Accounting Estimates Are Made

A38N. For entities with an internal audit function, its work may be relevant to the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates.

A38O. Areas where the work of the internal audit function may be particularly relevant include understanding:

- The nature and extent of management's use of accounting estimates;
- The design and implementation of control activities that address the risks related to the data, assumptions and models used to make the accounting estimates;
- The systems that generate the data on which the accounting estimates are based; and
- How new risks relating to accounting estimates are identified, assessed and managed.

Considerations Specific to Smaller Entities

A38P. In smaller entities, accounting estimates may be generated outside the general ledger, controls over their development may be limited, and an owner-manager may have significant influence over the determination. The owner-manager's role in making the accounting estimates may need to be taken into account by the auditor both when identifying the risks of material misstatement and when considering management bias.

ISA 315 (Revised)²⁰ includes specific considerations to smaller entities that the auditor might find helpful in obtaining an understanding of the components of internal control that are relevant to making accounting estimates.

Reviewing the Outcome or Re-Estimation of Previous Accounting Estimates (Ref: Para. 9)

A38Q. A retrospective review may be useful to the auditor in identifying and assessing the risks of material misstatement, specifically in circumstances when previous accounting estimates have an outcome through transfer or realization of the asset or liability, or are re-estimated for the purpose of the current period. In certain circumstances, a retrospective review may not assist the auditor in identifying and assessing the risks of material misstatement. For example, for many fair value accounting estimates, there is no observable outcome as the fair value is based on a hypothetical transaction to exchange an item at the reporting date.

A39. The outcome of an accounting estimate will often differ from the accounting estimate recognized in the previous period's financial statements. By performing risk assessment procedures to identify and understand the reasons for such differences, the auditor may obtain:

- Information regarding the effectiveness of management's previous estimation process, from which the auditor can obtain insight about the likely effectiveness of management's current process.
- Audit evidence that is pertinent to the re-estimation, in the current period, of previous accounting estimates.
- Audit evidence of matters, such as estimation uncertainty, that may be required to be disclosed in the financial statements.
- Information regarding the complexity and estimation uncertainty pertaining to the accounting estimates.
- Information regarding the susceptibility of accounting estimates to, or that may be an indicator of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

A39A. A retrospective review may be performed over accounting estimates made for prior period financial statements but also for accounting estimates made over several periods or a shorter period (such as half-yearly or quarterly). When entities make accounting estimates that are realized within a shorter timescale than full financial reporting periods, considering the outcomes of such accounting estimates may also provide important information about management's current effectiveness in making accounting estimates and other factors relevant to making estimates. Considering outcomes of accounting estimates that are realized between the end of the financial reporting period and the end of the audit may be useful for similar reasons.

²⁰ ISA 315 (Revised) paragraph A52, A56, A57, A88, A93, A95, A101, A102 and A108

- A41. A retrospective review of management judgments and assumptions related to significant accounting estimates is always required by ISA 240.²¹ As a practical matter, the auditor's review of previous accounting estimates as a risk assessment procedure in accordance with this ISA may be carried out in conjunction with the review required by ISA 240, when the auditor determines that performing a retrospective review will assist in identifying or assessing the risk of material misstatement.
- A42. The auditor may judge that a more detailed review is required for those accounting estimates that have changed significantly from the previous period, or for those accounting estimates for which the assessed risk of material misstatement in the previous period audit was not low or was low and that assessment includes an expectation that relevant controls were operating effectively. As part of the detailed review, the auditor may pay particular attention, when possible, to the effect of significant assumptions used in making the previous estimates.
- A43. For fair value accounting estimates and other accounting estimates based on current conditions at the measurement date more variation may exist between the fair value amount recognized in the previous period's financial statements and the outcome or the amount re-estimated for the purpose of the current period. This is because the measurement objective for such accounting estimates deals with perceptions about value at a point in time, which may change significantly and rapidly as the environment in which the entity operates changes. The auditor may therefore focus the review on obtaining information that would be relevant to identifying and assessing risks of material misstatement. For example, in some cases, obtaining an understanding of changes in marketplace participant assumptions which affected the outcome of a previous period's fair value accounting estimates may be unlikely to provide relevant information for audit purposes. If so, then the auditor's consideration of the outcome of previous period's fair value accounting estimates may be directed more towards understanding the effectiveness of management's prior estimation process, that is, management's track record, from which the auditor can judge the likely effectiveness of management's current process.
- A44. A difference between the outcome of an accounting estimate and the amount recognized in the previous period's financial statements does not necessarily represent a misstatement of the previous period's financial statements. However, it may do so if, for example, the difference arises from information that was available to management when the previous period's financial statements were finalized, or that could reasonably be expected to have been obtained and taken into account in the preparation of those financial statements. Many financial reporting frameworks contain guidance on distinguishing between changes in accounting estimates that constitute misstatements and changes that do not, and the accounting treatment required to be followed.

Specialized Skills or Knowledge (Ref: Para. 9A, 11A)

- A44A. In planning the audit, the auditor is required to ascertain the nature, timing and extent of resources necessary to perform the audit engagement.²² In some cases, the auditor may conclude that specialized skills or knowledge are required in relation to specific areas of

²¹ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph 32(b)(ii)

²² ISA 300, *Planning an Audit of Financial Statements*, paragraph 8(e)

accounting or auditing. In addition, ISA 220 requires the engagement partner to be satisfied that the engagement team, and any auditor's external experts, collectively have the appropriate competence and capabilities to perform the audit engagement.²³ During the course of the audit, the auditor may identify a need for specialized skills or knowledge to be applied in relation to one or more aspects of the accounting estimates.

A44B. Matters that may affect the auditor's consideration of whether specialized skills or knowledge is required include, for example:

- The nature of the accounting estimates for a particular business or industry (for example, mineral deposits, agricultural assets, complex financial instruments, insurance liabilities).
- The degree of estimation uncertainty.
- The complexity of the method or model used.
- The complexity of the requirements of the applicable financial reporting framework relevant to accounting estimates, including whether there are areas known to be subject to differing interpretation or practice or areas where there are inconsistencies in how accounting estimates are made.
- The procedures the auditor intends to undertake in responding to assessed risks.
- The need for judgment to be made about matters not specified by the financial reporting framework.
- The degree of judgment needed to select data and assumptions.
- The extent of the entity's use of information technology in making accounting estimates.

A44C. Many accounting estimates do not require the application of specialized skills or knowledge. For example, for most audits it is unlikely that specialized skills or knowledge would be necessary for an auditor to evaluate a bonus accrual. However, for expected credit losses of an internationally active banking institution or the insurance contract liability for an insurance entity, the auditor is likely to conclude that it is necessary to apply specialized skills or knowledge.

A44D. The auditor may not possess the specialized skills or knowledge required when the matter involved is in a field other than accounting or auditing and may need to use an auditor's expert. ISA 620²⁴ establishes requirements and provides guidance in determining the need to employ or engage an auditor's expert and the auditor's responsibilities when using the work of an auditor's expert.

A44E. Depending on the auditor's understanding and experience of working with the auditor's expert or other individuals with specialized skills or knowledge, the auditor may consider it appropriate to discuss matters such as the requirements of the applicable financial reporting framework with the individuals involved to establish that their work is relevant for audit purposes.

²³ ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

²⁴ ISA 620, *Using the Work of an Auditor's Expert*

Identifying and Assessing the Risks of Material Misstatement (Ref: Para. 10)

A44F. Obtaining an understanding of the entity and its environment, including the entity's internal control, as required by paragraph 8, assists the auditor in identifying areas of the financial statements that may be subject to potential misstatement and relevant risk factors that may give rise to potential risks of material misstatement related to accounting estimates.

A44G. Paragraph 10 requires the auditor, in assessing the risks of material misstatement, to take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including complexity, the use of judgment by management in making the estimate, and estimation uncertainty.

A44H. For some accounting estimates, the auditor's assessment of the risk of material misstatement may be low but not because that assessment includes an expectation that relevant controls are operating effectively (in other words, the assessed risk of material misstatement is primarily influenced by lower inherent risk). Examples may include:

- Depreciation calculations for an entity using a single depreciation method for property and equipment and a relatively low level of additions or disposals.
- Accounting estimates based on data that is readily available, such as published interest rate or foreign exchange rate data or exchange-traded prices of securities that are listed and actively traded on a recognized exchange, and few or no assumptions. An example of such an accounting estimate is the translation of a cash balance that is held in a currency other than the reporting currency.
- A bonus accrual for management which is based on performance indicators that are clearly identified.

A44I. For some accounting estimates, the extent to which they are subject to or affected by complexity, judgment or estimation uncertainty may be such that the assessed risk of material misstatement is not low, or is low but only because it includes an expectation that relevant controls are operating effectively. Examples may include:

- Accounting estimates relating to the outcome of litigation.
- Accounting estimates for financial instruments not publicly traded.
- Accounting estimates for which a complex model is used or for which there are assumptions or data that cannot be observed directly in the marketplace (level 3 fair values).
- Accounting estimates that collate, weight and integrate assumptions and data from a wide range of internal and external sources, such as an expected credit loss model in a financial institution that is active in different markets.
- Estimates of the development costs of a new pharmaceutical product.
- Estimates relating to undeveloped mineral resources.
- Valuation of goodwill in a business combination.

A44J. The reasons for the auditor's assessment of the risk of material misstatement may result from one or more of the factors of complexity, judgment and estimation uncertainty. For example:

- (a) Accounting estimates of expected credit losses are likely to be complex because the expected credit losses cannot be directly observed and may require the use of a complex model. The model may use a complex set of historical data and assumptions about future developments in a variety of entity specific scenarios that may be difficult to predict. Accounting estimates for expected credit losses are also likely to involve high estimation uncertainty and significant subjectivity in making judgments about future events or conditions.
- (b) A contrasting example may be an obsolescence provision for an entity with a wide range of different inventory types. Making the accounting estimate may require complex systems and processes, but may involve little judgment and the estimation uncertainty may be low.
- (c) Other accounting estimates may not be complex to make but may have high estimation uncertainty and require significant judgment, for example, an accounting estimate that requires a single critical judgment about a liability, the amount of which is contingent on the outcome of the litigation.

Significant Risks

A44K.Paragraph 28 of ISA 315 (Revised) and the related application material include factors that are required to be considered when identifying significant risks. If the auditor determines that an accounting estimate gives rise to a significant risk, the auditor is required to obtain an understanding of the entity's controls, including control activities.²⁵

A44L.In some cases, the estimation uncertainty relating to an accounting estimate may cast significant doubt about the entity's ability to continue as a going concern. ISA 570 (Revised)²⁶ establishes requirements and provides guidance in such circumstances.

Other Relevant Factors

A44M. In addition to complexity, judgment and estimation uncertainty, there may be other relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement. These may include the extent to which the accounting estimate is subject to, or affected by:

- A change in the nature or circumstances of the relevant financial statement items, requirements of the applicable financial reporting framework, or regulatory factors which may give rise to the need for changes in the method, assumptions or data used to make the accounting estimate;
- The susceptibility of the accounting estimate to the risk of a material misstatement due to fraud; and
- The regulatory environment, including relevant regulatory requirements.

Complexity

Complexity Arising from the Method Used in Making the Accounting Estimate (Ref: Para.

²⁵ ISA 315 (Revised), paragraph 29

²⁶ ISA 570, (Revised), *Going Concern*

10(a)(i))

A44N. Methods vary in the extent to which they involve complex concepts or techniques that require management to apply specialized skills or knowledge.²⁷ In addition, the nature of the measurement basis in the applicable financial reporting framework may result in the need for a complex method that requires multiple sources of historical and forward looking data or assumptions, with complex inter-relationships between them.

A44O. Complex methods are often applied using a complex model, particularly when the measurement basis requires the use of discounted cash flow techniques, projected or expected future cash flows and historical and forward looking data and assumptions obtained or developed from a combination of internal and external sources. Designing and operating such models often involves specialized skills or knowledge, including in relation to valuation attributes arising from the nature and circumstances of the underlying financial statement items and in the use of information technology.

A44P. Examples of accounting estimates in relation to which complex models are likely to be used include:

- An impairment loss for goodwill or an intangible asset, which may require expectations about future cash flows from the business, asset or a group of related assets to be developed based on historical data and forward looking assumptions.
- An expected credit loss, which may require expectations of future credit repayments and other cash flows, based on historical experience data and forward looking assumptions.
- An insurance contract liability, which may require expectations about future insurance contract payments to be projected based on historical experience and current and assumed future trends.
- A level 3 fair value based on cash flow projections and historical market related data.

Complexity Arising from the Data on Which the Accounting Estimates Are Based (Ref: Para. 10(a)(ii))

A44Q. Risks of material misstatement related to complexity in making accounting estimates may arise when such complexity leads to greater difficulty in obtaining, or in maintaining the integrity of, relevant and reliable data, stemming from one or a combination of the following:

- The reliability of the data source. Data from certain sources may be more reliable than from others. For example, data obtained from internal systems outside the general and subsidiary ledgers may be more susceptible to misstatements because in some entities it may be difficult to determine whether there were appropriate controls and governance over that data.
- Data from an external information source may be less relevant in making a fair value estimate if it is not based on observable market transactions. For example, it may be less relevant when it is based on brokers' quotes that reflect brokers' subjective judgments in the context of an inactive market. In addition, for

²⁷ See for examples of complex techniques paragraph 8 of Appendix 2

confidentiality or proprietary reasons, some external information sources will not (or not fully) disclose information that may be relevant in considering the relevance and reliability of the data they provide, such as the sources of the underlying data they used or how it was accumulated and processed (including any controls over the process). It may be more difficult to consider the relevance and reliability of such data than in the case of data from more transparent external information sources.

- The integrity of the information systems. Data that is used to make the accounting estimates may be processed by complex information systems which may require effective information technology general controls, and controls over the flow of data through the system.
- A complex organizational structure or a lack of integration between systems in different parts of the entity may give rise to difficulty in reliably and consistently aggregating.
- The volume of data or the source of the data, including data that comes from a wide variety of sources. This may lead to the risk that the data may be inappropriately used, or may be incomplete or from an incorrect data set.

Judgment (Ref: Para. 10(b))

A44R Judgment may be used by management in the selection or application of appropriate methods, the selection or development of appropriate assumptions, and the selection or interpretation of data. The risks of material misstatement related to judgment involved in making accounting estimates may relate to one or a combination of the following:

- A lack of experience or competence by management, including a lack of availability to management of required skills or knowledge. These factors may result in risks related to the selection of inappropriate methods, assumptions and data. When management lacks the competence or experience in a certain area and decides not to use a management's expert, there may be a risk that:
 - The method selected may not comply with the applicable financial reporting framework.
 - Management may select a data source that is not relevant and reliable.
- Indicators of management bias.
- The extent to which the applicable financial reporting framework does not specify the appropriate valuation approaches, concepts, techniques and factors to use in the estimation method and therefore may require significant judgment.

A44S. Examples of accounting estimates that are likely to be subject to a high degree of judgment include the following:

- Accounting estimates that are based on expected future cash flows for which there is uncertainty regarding the amount or timing.
- Accounting estimates that are based on complex contractual terms. For example, the determination of cash inflows or outflows arising from commercial supplier or customer rebates may depend on very complex contractual terms that require specific expertise or competence.

- Accounting estimates with a long forecast period.

A44T. When accounting estimates are subject to a high degree of judgment, the accounting estimate may be more susceptible to the potential for management bias, particularly when this judgment involves greater subjectivity. For example, such judgment may result in a wide range of possible measurement of the accounting estimate. Management may select a point estimate from that range that is inappropriate in the circumstances, or that is inappropriately influenced by unintentional or intentional management bias, and that is therefore misstated.

Estimation Uncertainty (Ref: Para. 10(c))

A44U. Estimation uncertainty arises from factors that give rise to an inherent lack of precision in the measurement of an accounting estimate. The variation in the measurement of an accounting estimate that results from estimation uncertainty is not in itself a misstatement. A risk of material misstatement related to estimation uncertainty arises from variables that increase the likelihood that management's point estimate and related disclosures are not reasonable in the context of the applicable financial reporting framework.

A44V. Estimation uncertainty may arise, for example, when it is not possible (or not practical, insofar as permitted by the applicable financial reporting framework) for management:

- To make a precise and reliable prediction about the future realization of a past transaction (for example, the amount that will be paid under a contingent contractual term), or about the incidence and impact of future events or conditions (for example, the amount of a future credit loss or the amount that will be settled for a future insurance claim); or
- To obtain precise and complete information about a present condition (for example, information about valuation attributes that would reflect the perspective of market participants at the date of the financial statements, to develop a fair value estimate).

A44W. The risk of material misstatement related to estimation uncertainty may relate to one or a combination of the following:

- The applicable financial reporting framework, which may require:
 - The use of a method to make the accounting estimates that inherently has a high level of estimation uncertainty. For example, the financial reporting framework may require the use of a level 3 fair value.
 - The use of assumptions that inherently have a high level of estimation uncertainty, such as future cash flows for a long-term contract, assumptions that are based on data that is unobservable and are therefore difficult for management to develop or the use of the various assumptions that are interrelated.
 - Disclosures about estimation uncertainty. There may be a risk of material misstatement related to the failure to make a material disclosure about the estimation uncertainty.
- The business environment. An entity may be active in a market that experiences turmoil or possible disruption (for example, from major currency movements or inactive markets) and the accounting estimate may therefore be dependent on data

that is not readily observable.

- A48. A seemingly immaterial accounting estimate may have the potential to result in a material misstatement due to the estimation uncertainty associated with the accounting estimate; that is, the size of the amount recognized or disclosed in the financial statements for an accounting estimate is not, in itself, an indicator of its estimation uncertainty.
- A49. In some circumstances, the estimation uncertainty is so high that a reasonable accounting estimate cannot be made. The applicable financial reporting framework may, therefore, preclude recognition of the item in the financial statements, or its measurement at fair value. In such cases, there may be risks of material misstatement that relate not only to whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the reasonableness of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the estimation uncertainty associated with them (see paragraphs A120-A123).
- A49A. Not all accounting estimates are affected by high levels of estimation uncertainty. For example, some financial statement items may have an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur. However, estimation uncertainty may exist even when the valuation method and data are well defined. For example, valuation of securities quoted on an active and open market at the listed market price may require adjustment if the holding is significant in relation to the market or is subject to restrictions in marketability. In addition, general economic circumstances prevailing at the time, for example, illiquidity in a particular market, may impact estimation uncertainty.
- A49B. A sensitivity analysis may demonstrate that the accounting estimate is sensitive to one or more assumptions that then become the focus of the auditor's attention.
- A49C. The degree of estimation uncertainty associated with an accounting estimate may influence its susceptibility to management bias. When the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor's application of professional skepticism is particularly important.

Responses to the Assessed Risks of Material Misstatement (Ref: Para. 13)

- A57A. In designing further audit procedures, ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance or disclosure (that is, the inherent risk), and whether the risk assessment takes account of relevant controls (that is, control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively.
- A57B. Paragraph A40 of ISA 200²⁸ states that the ISAs do not ordinarily refer to inherent risk and control risk separately. However, the auditor may make separate or combined assessments of inherent and control risk. Although this ISA neither implies nor requires

²⁸ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

a separate assessment of inherent and control risk, it highlights the importance of the auditor's consideration of both inherent and control risk in designing and performing further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level in accordance with ISA 330.

A57C. In identifying the risks of material misstatement for accounting estimates, paragraph 10 requires the auditor to take into account the extent to which the estimate is subject to, or affected by relevant factors, including complexity, the need for the use of judgment by management in making the accounting estimate, and estimation uncertainty (i.e., the reasons for the assessment given to the risk of material misstatement).

A57D. Accounting estimates, by their nature, will vary and be subject to differing levels of assessed risk of material misstatement. Therefore, the nature, timing and extent of the further audit procedures performed to respond to the assessed risks of material misstatement at the assertion level, in accordance with ISA 330, will also vary in relation to the nature of the accounting estimate, the level of assessed risk and the reasons for the assessment given to the risk.

A57E. In certain circumstances, it may not be possible or practicable for the auditor to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level. For example, this may be the case for entities such as large banks, insurers, and telecommunication entities that make extensive use of IT to conduct their business or have a large number of accounting estimates, many of which are highly judgmental or complex. Factors that may indicate that substantive procedures alone may not provide sufficient appropriate audit evidence at the assertion level include:

- The volume of transactions (for example, a high volume of transactions may occur in a large bank, insurer or telecommunication entity, making it more difficult to design substantive procedures that alone provide sufficient appropriate audit evidence at the assertion level).
- Whether significant information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported. For such assertions, audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over the accuracy and completeness of the information. In addition, the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively.
- The need to combine information from the general and subsidiary ledgers with information obtained from outside the general and subsidiary ledgers (for example, an expected credit loss may require information from the entity's risk management system). In these situations, it may not be possible to design and perform substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level.

A57F. In some jurisdictions, as part of the audit of the financial statements for certain entities (such as a bank or insurer), the auditor also may be required by law or regulation to undertake additional work to provide assurance on internal controls.

Considerations Specific to Smaller Entities

A57G. Controls over the process to make an accounting estimate may exist in smaller entities, but their formality may vary. Further, smaller entities may determine that certain types of controls are not necessary because of active management involvement in the financial reporting process. In the case of very small entities, however, there may not be many controls that the auditor can identify. For this reason, the auditor's response to the assessed risks is more likely to be substantive in nature.

Accounting Estimates with Low Assessed Risk of Material Misstatement but Not Because that Assessment Includes an Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(a))

A57H. For some accounting estimates, such as those described in paragraph , the extent to which they are affected by, or subject to, complexity, the need for the use of judgment, and estimation uncertainty may be such that the assessed risk of material misstatement at the assertion level is low, but not because that assessment includes an expectation that relevant controls are operating effectively (in other words, the assessed risk of material misstatement is primarily influenced by lower inherent risk). In these circumstances, the auditor may determine that a procedure that addresses management's point estimate at an overall level is sufficiently responsive to the assessed risk of material misstatement. For such accounting estimates, the following procedures may be appropriate:

- Obtaining audit evidence about events occurring up to the date of the auditor's report;
- Developing a point estimate or range based on available audit evidence to evaluate management's point estimate; or
- Performing substantive analytical procedures.

Accounting Estimates with Low Assessed Risk of Material Misstatement and that Assessment Includes an Expectation that Relevant Controls Are Operating Effectively (Ref. Para: 13(b))

A57I. As indicated in paragraph 13(b), the auditor may have assessed the risk of material misstatement as low and that assessment includes an expectation that relevant controls are operating effectively. When this is the case, the auditor is required to perform tests of the relevant controls to obtain audit evidence about their operating effectiveness in accordance with ISA 330. In some circumstances, the tests of controls may not be sufficient, by themselves, to appropriately address the reasons for the assessment given to the risk of material misstatement. If not, the auditor is required by ISA 330 to perform substantive procedures.

Accounting Estimates with an Assessed Risk of Material Misstatement that is Not Low (Ref. Para: 13(c))

A57J. For some accounting estimates, such as those described in paragraph A44J, the extent of complexity, judgment or estimation uncertainty (either individually or in combination) is more likely to influence the auditor's assessment of the risk of material misstatement for the estimate (that is, the auditor's assessment of the risk of material misstatement may be higher as the extent of complexity, judgment and estimation uncertainty involved increases).

A57K. In these circumstances, paragraph 13(c) requires the auditor to design and perform further audit procedures (whether substantive procedures or tests of controls) to obtain audit evidence about the matters in paragraphs 13A to 13C, when applicable. Such procedures also are required to be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needed.

A57L. As explained in ISA 330,²⁹ the nature of the procedures is of most importance in responding to the assessed risks. In addition, the reasons for the assessment given to a risk are relevant in determining the nature of audit procedures.³⁰ The timing and extent of the further audit procedures will vary based on the assessed risk of material misstatement.

Complexity (Ref: Para. 13A)

A59A. When management uses a complex method, an important factor that the auditor may need to consider regarding the appropriateness of the method, and significant data and assumptions, is whether there were other available valuation concepts, techniques or factors, types of assumptions or sources of data that, in the circumstances, might have been more appropriate, or more generally accepted, in the context of the applicable financial reporting framework. The auditor may also consider whether management was able to obtain access to the appropriate skills and knowledge involved in applying the complex method.

Complex Modelling

A59B. In some cases, management may use a complex model to make an accounting estimate. Whether the complex model used is appropriate in the context of the applicable financial reporting framework may depend on a number of factors, such as the nature of the entity and its environment, including the industry in which it operates, and the specific item being measured.

A59C. The nature and extent of the procedures that may be performed with respect to the complex model depends on its complexity. When complex modelling is needed, the assessed risk of material misstatement is likely to be higher and, therefore, the more persuasive the audit evidence that may need to be obtained.

A59D. The extent to which the following considerations are relevant depends on the circumstances, including whether the complex model is obtained from a third party, or is a proprietary model. Depending on the circumstances, matters that the auditor may consider include, for example, whether:

- The model is validated prior to usage, with periodic reviews to ensure it is still suitable for its intended use. The entity's validation process may include evaluation of:
 - The model's theoretical soundness;
 - The model's mathematical integrity;
 - The accuracy and completeness of the model's data and assumptions; and

²⁹ ISA 330, paragraph A5

³⁰ ISA 330, paragraph A10

- The model's output as compared to actual transactions.
- Appropriate change control policies and procedures exist.

Understanding or Interpreting Data (Ref: Para. 13A(c))

A59E. An accounting estimate may be based on data that needs to be understood or interpreted. For example, a contract may include complex terms that management needs to understand and interpret based on the facts and circumstances of the entity. Procedures that the auditor may consider when the accounting estimate is based on complex legal or contractual terms include:

- Considering whether specialized skills or knowledge are needed to understand or interpret the contract;
- Inquiring of the entity's legal counsel regarding the legal or contractual terms; and
- Inspecting the underlying contracts, and:
 - Obtaining an understanding of, and evaluating, the underlying business purpose for the transaction or agreement; and
 - Considering whether the terms of the contracts are consistent with management's explanations.

Integrity of Significant Data and Assumptions (Ref: Para. 13A(d))

A59F. Data may be developed internally, or may be obtained from an external information source. When obtaining audit evidence about the integrity of data and assumptions, it may be appropriate for the auditor to compare the data and assumptions with an external information source.

Judgment

The Selection of Methods and the Significant Data and Assumptions (Ref: Para. 13B(a)(i))

A59G. Audit evidence regarding management's selection of methods and significant data and assumptions may be obtained from inquiries of management regarding management's continuing processes of strategic analysis and risk management and inspection of relevant documents (such as committee minutes). Even without formal established processes, such as may be the case in smaller entities, the auditor may be able to evaluate the significant data and assumptions through inquiries of, and discussions with, management, along with other audit procedures in order to obtain sufficient appropriate audit evidence.

Changes From Previous Periods in the Method, or the Significant Data or Assumptions (Ref: Para. 13B(a)(ii))

A59H. The auditor's consideration of a change in an accounting estimate, or in the method for making it from the prior period, is important because a change that is not based on a change in circumstances or new information is unlikely to be reasonable nor in compliance with the applicable financial reporting framework. Arbitrary changes in an accounting estimate result in inconsistent financial statements over time and may give rise to a financial statement misstatement or be an indicator of possible management bias. (see paragraphs A121B–A121F).

A59I. Management often is able to demonstrate good reason for a change in an accounting estimate, the method for making an accounting estimate, or the significant data or assumptions used from one period to another based on a change in circumstances. What constitutes a good reason, and the adequacy of support for management's contention that there has been a change in circumstances that warrants a change in an accounting estimate or the method for making an accounting estimate, are matters of judgment.

A59J. As part of the process of making changes to the methods, assumptions, and data used in previous periods, management may evaluate alternative assumptions or outcomes of the accounting estimates, which can be accomplished through a number of approaches depending on the circumstances. One possible approach is a sensitivity analysis. This might involve determining how the monetary amount of an accounting estimate varies with different assumptions. Even for accounting estimates measured at fair value, there can be variation because different market participants will use different assumptions. A sensitivity analysis could lead to the development of a number of outcome scenarios, sometimes characterized as a range of outcomes by management, such as "pessimistic" and "optimistic" scenarios.

A59K. This is not intended to suggest that one particular approach is more suitable than another, or that management's consideration of alternative assumptions or outcomes needs to be conducted through a detailed process supported by extensive documentation. Rather, it is whether management has assessed the effect on the accounting estimate that is important, not the specific manner in which it is done. Accordingly, where management has not considered alternative assumptions or outcomes, it may be necessary for the auditor to discuss with management, and request support for, how it has addressed the effects of estimation uncertainty on the accounting estimate (see paragraph 13C(a)).

Considerations specific to smaller entities

A59L. Smaller entities may use simple means to assess alternative assumptions or outcomes. In addition to the auditor's review of available documentation, the auditor may obtain other audit evidence of management's consideration of alternative assumptions or outcomes by inquiry of management. In addition, management may not have the expertise to consider alternative assumptions or outcomes and, therefore, may need to obtain specialized skills or knowledge from an external party (see also paragraph 8(c)(iii)).

Management's Intent and Ability (Ref: Para. 13B(b))

A59M. The reasonableness of the assumptions used may depend on management's intent and ability to carry out certain courses of action. Management often documents plans and intentions relevant to specific assets or liabilities and the financial reporting framework may require it to do so. Although the extent of audit evidence to be obtained about management's intent and ability is a matter of professional judgment, the auditor's procedures may include the following:

- Review of management's history of carrying out its stated intentions.
- Review of written plans and other documentation, including, where applicable, formally approved budgets, authorizations or minutes.

- Inquiry of management about its reasons for a particular course of action.
- Review of events occurring subsequent to the date of the financial statements and up to the date of the auditor's report.
- Evaluation of the entity's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its existing commitments and legal, regulatory, or contractual restrictions that could affect the entity's ability to carry out the course of action.
- Consideration of whether management has met the applicable documentation requirements, if any, of the applicable financial reporting framework.

Certain financial reporting frameworks, however, may not permit management's intentions or plans to be taken into account when making an accounting estimate. This is often the case for fair value accounting estimates because their measurement objective requires that assumptions reflect those used by marketplace participants.

Model Adjustments (Ref: Para. 13B(c)(iii))

A59N. When management has made adjustments to the output of the model (see paragraph A25A to meet the requirements of the applicable financial reporting framework, consideration of those adjustments is likely to be important in obtaining sufficient appropriate audit evidence over risks of material misstatement related to the use of judgment by management. Several types of methods used for the valuation of accounting estimates that require adjustments are for example, fulfilment value accounting for valuing insurance contracts and overlay adjustments when accounting for expected credit losses. In the case of fair value accounting estimates, it may be relevant to consider whether adjustments to the output of the model, if any, reflect the assumptions marketplace participants would use in similar circumstances.

Estimation Uncertainty

Management's Steps to Understand and Address Estimation Uncertainty (Ref: Para. 13C(a))

A59O. When evaluating the steps, if any, management has taken to understand and address estimation uncertainty, the auditor may consider whether the method's (including, when applicable, the model's) design minimizes estimation uncertainty.

Disclosures of estimation uncertainty for accounting estimates (Ref: Para 13C(a)(ii)(b))

A60A. Even when the disclosures are in accordance with the applicable financial reporting framework, the auditor may conclude that the disclosure of estimation uncertainty is unreasonable in light of the circumstances and facts involved. The auditor's evaluation of the reasonableness of disclosure of estimation uncertainty increases in importance the greater the range of possible outcomes of the accounting estimate is in relation to materiality (see paragraphs A60K–A60L).

A60B. In some cases, the auditor may consider it appropriate to encourage management to describe, in the notes to the financial statements, the circumstances relating to the estimation uncertainty. ISA 705 (Revised)³¹ provides guidance on the implications for the auditor's opinion when the auditor believes that management's disclosure of estimation

³¹ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

uncertainty in the financial statements is inadequate or misleading. If the auditor's consideration of estimation uncertainty associated with an accounting estimate, and its related disclosure, is a matter that required significant auditor attention, then this may constitute a key audit matter (see ISA 701).³²

When Management Has Not Appropriately Addressed Estimation Uncertainty (Ref: Para. 13C(b))

A60C. In preparing the financial statements, management may be satisfied that it has appropriately addressed the effects of estimation uncertainty. In some circumstances, however, the auditor may view the efforts of management as inappropriate. This may be the case, for example, when, in the auditor's judgment:

- Sufficient appropriate audit evidence could not be obtained through the auditor's evaluation of how management has addressed the effects of estimation uncertainty.
- It is necessary to explore further the degree of estimation uncertainty associated with an accounting estimate, for example, where the auditor is aware of wide variation in outcomes for similar accounting estimates in similar circumstances.
- It is unlikely that other information can be obtained, for example, through the review of events occurring up to the date of the auditor's report.
- Indicators of management bias in the making of accounting estimates may exist.

A60D. When the auditor believes that the efforts of management are inappropriate, the auditor may consider requesting management to consider alternative assumptions or to provide additional disclosure relating to the estimation uncertainty.

A60E. If, in the auditor's judgment, management has not appropriately addressed the effect of estimation uncertainty, the auditor is required to develop a point estimate or a range to enable the auditor to evaluate the reasonableness of management's point estimate and the disclosures in the financial statements that describe the estimation uncertainty.

A60F. When developing a point estimate or range, the auditor may use different assumptions or a different method from those used by management. It is important for the auditor to obtain a sufficient understanding of the assumptions or method used by management in making the accounting estimate as these may be relevant to the auditor's development of an appropriate point estimate or range and to understand the differences between the auditor's point estimate or range and management's.

A60G. For example, a difference may arise because the auditor used different assumptions compared with those used by management, but both sets of assumptions could be valid in the context of the applicable financial reporting framework. This may reveal that the accounting estimate is sensitive to certain assumptions and therefore subject to estimation uncertainty. Alternatively, a difference may arise as a result of a factual error made by management. Depending on the circumstances, the auditor may find it helpful in drawing conclusions to discuss with management the basis for the assumptions used and their validity, and the difference, if any, in the approach taken to making the accounting estimate.

³² ISA 701, Communicating Key Audit Matters in the Independent Auditor's Report

A60H. The approach taken by the auditor in developing either a point estimate or a range may vary based on what is considered most effective in the circumstances. For example, the auditor may initially develop a point estimate, and then assess its sensitivity to changes in assumptions to ascertain a range with which to evaluate management's point estimate. Alternatively, the auditor may begin by developing a range for purposes of determining, when possible, a point estimate.

A60I. The ability of the auditor to develop a point estimate, as opposed to a range, depends on several factors, including the method used, the nature and extent of data available and the estimation uncertainty involved with the accounting estimate. Further, the decision to develop a point estimate or range may be influenced by the applicable financial reporting framework, which may prescribe the point estimate that is to be used after consideration of the alternative outcomes and assumptions, or prescribe a specific measurement method (for example, the use of a discounted probability-weighted expected value, or the most likely outcome).

A60J. The auditor may develop a point estimate or a range in a number of ways, for example, by:

- Using a model, for example, one that is commercially available for use in a particular sector or industry, or a proprietary or auditor-developed model.
- Using management's model and selecting alternative assumptions or data sources to develop a point estimate or range.
- Developing a point estimate or range for only part of the accounting estimate (for example, when only a certain part of the accounting estimate is giving rise to the risk of material misstatement).
- Further developing management's consideration of alternative assumptions or outcomes, for example, by introducing a different set of assumptions.
- Employing or engaging a person with specialized expertise to develop or execute the model, or to provide relevant assumptions.
- Making reference to other comparable conditions, transactions or events, or, where relevant, markets for comparable assets or liabilities.

A60K. The appropriate methods, assumption and data to use depend on the requirements of the applicable financial reporting framework, and other factors.

The Boundaries of a Range (Ref: Para. 13C(c))

A60L. A range cannot be one that comprises all possible outcomes if it is to be useful, as such a range would be too wide to be effective for purposes of the audit.

A60M. In certain industries, such as financial services or extractive industries, it may not be possible to develop a range within performance materiality and, in some cases, may be multiples of performance materiality. This does not necessarily preclude recognition of the accounting estimate based on the audit evidence obtained. It may indicate, however, that the estimation uncertainty associated with the accounting estimate is such that it gives rise to a significant risk.

Disclosures Related to Accounting Estimates (Ref: Para.13D)

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

- The method of estimation used, including any applicable model.
- The basis for the selection of the method of estimation.
- Information that has been obtained from models, or from other calculations used to determine estimates recognized or disclosed in the financial statements, including information relating to the underlying data and assumptions used in those models, such as:
 - Assumptions developed internally; or
 - Data, such as interest rates, that are affected by factors outside the control of the entity.
- The effect of any changes to the method of estimation from the prior period.
- The sources and implications of estimation uncertainty.
- Fair value information, including when produced by management's experts.
- Information about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.

Such disclosures are relevant to users in understanding the accounting estimates recognized or disclosed in the financial statements, and sufficient appropriate audit evidence needs to be obtained about whether the disclosures are reasonable in the context of the applicable financial reporting framework.

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

- The disclosure of key assumptions and other sources of estimation uncertainty that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities. Such requirements may be described using terms such as "Key Sources of Estimation Uncertainty" or "Critical Accounting Estimates."
- The disclosure of the range of possible outcomes, and the assumptions used in determining the range.
- The disclosure of specific information, such as:
 - Information regarding the significance of fair value accounting estimates to the entity's financial position and performance; and
 - Disclosures regarding market inactivity or illiquidity.
- Qualitative disclosures such as the exposures to risk and how they arise, the entity's objectives, policies and procedures for managing the risk and the methods

used to measure the risk and any changes from the previous period of these qualitative concepts.

- Quantitative disclosures such as the extent to which the entity is exposed to risk, based on information provided internally to the entity's key management personnel, including credit risk, liquidity risk and market risk.

A121A. When the financial statements are prepared in accordance with a fair presentation framework, the auditor's evaluation as to whether the financial statements achieve fair presentation may include the consideration of the overall presentation, structure and content of the financial statements, and whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation. Depending on the facts and circumstances, given the importance of accounting estimates to the overall financial statements, the auditor may determine that additional disclosures related to accounting estimates are necessary to achieve fair presentation. This may be the case, for example, when an accounting estimate is subject to significant estimation uncertainty (see paragraphs A122-A123).

Overall Evaluation Based on Audit Procedures Performed (Ref: Para. 13E)

A121B. ISA 330³³ notes that an audit of financial statements is a cumulative and iterative process. As the auditor performs planned audit procedures, the audit evidence obtained may cause the auditor to modify the nature, timing or extent of other planned audit procedures. In relation to accounting estimates, information may come to the auditor's attention through performing procedures to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable, that differs significantly from the information on which the risk assessment was based.

A121C. For example, the auditor may have identified that the reasons for an assessed risk of material misstatement are limited to the judgment used by management in making the accounting estimate. However, while performing procedures to address the matters in paragraph 13B, as applicable, the auditor may discover that the accounting estimate is more complex than originally contemplated, indicating that the assessment of the risk of material misstatement may need to be revised (that is, the reasons for the assessment now include complexity). Therefore, the auditor may need to perform additional audit procedures to address the matters in paragraph 13A, as applicable. ISA 315 (Revised) contains further guidance on revising the auditor's risk assessment.³⁴

A121D. With respect to accounting estimates that have not been recognized, the focus of the auditor's evaluation may be on whether the recognition criteria of the applicable financial reporting framework have in fact been met. When an accounting estimate has not been recognized, and the auditor concludes that this treatment is appropriate, some financial reporting frameworks may require disclosure of the circumstances in the notes to the financial statements.

³³ ISA 330, paragraph A60

³⁴ ISA 315, paragraph 31

Misstatements (Ref: Para.13F)

A121E. ISA 450³⁵ provides guidance on distinguishing misstatements for purposes of the auditor's evaluation of the effect of uncorrected misstatements on the financial statements. In relation to accounting estimates, a misstatement, whether caused by fraud or error, may arise as a result of:

- Misstatements about which there is no doubt (factual misstatements).
- Differences arising from management's judgments concerning accounting estimates that the auditor considers unreasonable, or the selection or application of accounting policies that the auditor considers inappropriate (judgmental misstatements).
- The auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn (projected misstatements).

A121F. Based on the audit evidence obtained, the auditor may conclude that there is sufficient appropriate audit evidence supporting a point estimate that does not differ from management's point estimate, or a range that includes management's point estimate, which may lead the auditor to conclude that the accounting estimate is reasonable in the context of the applicable financial reporting framework.

A121G. Alternatively, the audit evidence may support a point estimate that differs from management's point estimate, or a range that does not include management's point estimate. When the audit evidence supports an auditor's point estimate that differs from management's point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. When the audit evidence supports a range that does not encompass management's point estimate, the difference between management's point estimate and a point in the auditor's range is a misstatement. In such cases, the misstatement is not less than the difference between management's point estimate and the nearest point of the auditor's range, but could be greater.

A121H. Evaluating whether sufficient appropriate audit evidence has been obtained, and whether the accounting estimate is misstated, for accounting estimates and related disclosures included in the notes to the financial statements involves essentially the same types of considerations applied when auditing an accounting estimate recognized in the financial statements.

Indicators of Possible Management Bias (Ref: Para. 21)

A121I. Examples of indicators of possible management bias with respect to accounting estimates include:

- Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
- Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.

³⁵ ISA 450, *Evaluation of Misstatements Identified during the Audit*

- Selection of a point estimate that may indicate a pattern of optimism or pessimism.

A121J. Indicators of possible management bias themselves do not constitute misstatements for purposes of drawing conclusions on the reasonableness of individual accounting estimates. However, in some cases the audit evidence may point to a misstatement rather than simply an indicator of bias. For example, when management has changed an accounting estimate, or the method of making it, from the prior period based on a subjective assessment that there has been a change in circumstances, the auditor may conclude based on the audit evidence obtained that the accounting estimate is misstated as a result of an arbitrary change by management, or may regard it as an indicator of possible management bias.

A121K. Management bias may be more difficult to detect at an account level than when considering groups of accounting estimates or all accounting estimates, or when observed over a number of accounting periods. Although some form of management bias is inherent in subjective decisions, in making such judgments there may be no intention by management to mislead the users of financial statements. Where, however, there is intention to mislead, management bias is fraudulent in nature.

A121L. For example, if each accounting estimate included in the financial statements was individually reasonable but each management point estimate trends toward one end of the auditor's range, such circumstances may indicate possible bias by management in making the estimates. Bias may also be evident from the cumulative effect of changes in multiple accounting estimates. For example, if the estimates in the financial statements are grouped at one end of the range of reasonable outcomes in the prior year and are grouped at the other end of the range of reasonable outcomes in the current year, such changes may be an indicator of possible bias in seeking to achieve an expected or desired outcome, e.g., to offset higher or lower than expected earnings.

A121M. Indicators of management bias may affect the auditor's conclusion as to whether the auditor's risk assessment and related responses remain appropriate, and the auditor may need to consider the implications for the rest of the audit. Further, they may affect the auditor's evaluation of whether the financial statements as a whole are free from material misstatement, as discussed in ISA 700 (Revised).

A121N. In addition, in applying ISA 240, the auditor is required to evaluate whether management's judgments and decisions in making the accounting estimates included in the financial statements indicate a possible bias that may represent a material misstatement due to fraud. Fraudulent financial reporting is often accomplished through intentional misstatement of accounting estimates, which may include intentionally understating or overstating accounting estimates. Possible indicators of management bias that may also be indicators of a fraud risk may cause the auditor to reassess whether the auditor's risk assessments, in particular the assessment of fraud risks, and related responses remain appropriate.

Written Representations (Ref: Para. 22)

A126. ISA 580³⁶ discusses the use of written representations. In obtaining written representations that management and, where appropriate, those charged with governance believe the methods and significant data and assumptions used in making

³⁶ ISA 580, *Written Representations*

the accounting estimates and their related disclosures are appropriate, the auditor is required to consider the need to obtain representations about specific accounting estimates. These representations may address accounting estimates recognized or disclosed, or about decisions not to recognize or disclose an accounting estimate, in the financial statements and may include representations:

- About the appropriateness of the method selected and, where applicable, the model used for making the accounting estimate in the context of the applicable financial reporting framework.
- That the significant assumptions and data sources, including any external information sources, used as inputs in making the accounting estimates are relevant, reliable and appropriate in the context of the applicable financial reporting framework.
- That the significant judgments made in making the accounting estimate have been taken into account all relevant information of which management is aware.
- About the consistency in the selection or application of the method, assumptions and data used by management in making the accounting estimates in the context of the applicable financial reporting framework.
- That the assumptions appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity, where relevant to the accounting estimates and disclosures.
- That disclosures related to accounting estimates, including disclosures describing estimation uncertainty, are complete and appropriate under the applicable financial reporting framework.
- That appropriate specialized skills or expertise, where necessary, has been applied in making the accounting estimates.
- That no subsequent event requires adjustment to the accounting estimates and disclosures included in the financial statements.

A127. For those accounting estimates not recognized or disclosed in the financial statements, written representations may also include representations about the appropriateness of the basis used by management for determining that the recognition or disclosure criteria of the applicable financial reporting framework have not been met (see paragraph A114).

Communication with Those Charged With Governance (Ref: Para 22A)

A127A. In applying ISA 260 (Revised), the auditor communicates with those charged with governance the auditor's views about significant qualitative aspects of the entity's accounting practices relating to accounting estimates and related disclosures. This may include, when applicable, why the auditor considers a significant accounting practice, which include management's judgments in making the accounting estimates, although acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity. In communicating those views, matters specific to the accounting estimates that the auditor may consider communicating to those charged with governance include:

- (a) The nature and consequences of significant assumptions used in accounting estimates and the degree of subjectivity involved in the development of the assumptions;
- (b) The relative materiality of the accounting estimates to the financial statements as a whole;
- (c) Management's understanding (or lack thereof) regarding the nature and extent of, and the risks associated with, accounting estimates, particularly financial instruments;
- (d) Significant difficulties encountered when obtaining sufficient appropriate audit evidence relating to data obtained from an external data source or valuations performed by management or a management's expert;
- (e) Significant differences in judgments between the auditor and management or a management's expert regarding valuations;
- (f) The auditor's views about differences between the auditor's point estimate or range and management's point estimate;
- (g) The auditor's views about the appropriateness of the selection of accounting policies and presentation of accounting estimates in the financial statements;
- (h) The auditor's views about the qualitative aspects of the entity's accounting practices and financial reporting for accounting estimates; and
- (i) The potential effects on the entity's financial statements of material risks and exposures required to be disclosed in the financial statements, including the estimation uncertainty associated with accounting estimates.

A121B. In applying ISA 265, the auditor communicates significant deficiencies in internal control to those charged with governance or management, including significant deficiencies regarding accounting estimates. Such communications may include, for example, significant deficiencies related to controls over:

- (a) The selection and application of significant accounting policies related to accounting estimates, and the selection and application of methods, assumptions, and data;
- (b) Risk management and related systems;
- (c) Data integrity, including when data is obtained from an external information source; and
- (d) The use, development and validation of models, including third-party models, and any adjustments that may be required.

A127C. In addition to communicating with those charged with governance, the auditor may be permitted or required to communicate directly with regulators or prudential supervisors. Such communication may be useful throughout the audit or at particular stages, such as when planning the audit or when finalizing the auditor's report. For example, in some jurisdictions, financial institution regulators seek to cooperate with auditors to share information about the operation and application of controls over financial instrument activities, challenges in valuing financial instruments in inactive markets, expected credit losses, and insurance reserves while other regulators may seek to understand the

auditor's views on significant aspects of the entity's operations including the entity's costs estimates. This communication may be helpful to the auditor in identifying risks of material misstatement.

Documentation (Ref: Para. 23)

A128. Documentation of indicators of possible management bias identified during the audit assists the auditor in concluding whether the auditor's risk assessment and related responses remain appropriate, and in evaluating whether the financial statements as a whole are free from material misstatement. See paragraph A121E for examples of indicators of possible management bias.

Appendix 1

(Ref: Para. 2A–2B)

Measurement Bases of Accounting Estimates

1. The purpose of this appendix is to explain the range of different types of measurement bases that may be used in making an accounting estimate. It is intended to provide context for the auditor's consideration of the extent to which the factors of complexity, the need for the use of judgment, and estimation uncertainty may be inherent in the use of a particular measurement basis.
2. Depending on the characteristics of the measurement basis applied and on the nature and circumstances of the financial statement item, monetary amounts may need to be estimated. Examples of circumstances when accounting estimates may be required when applying a range of common measurement bases are discussed below.
3. Measurement bases reflect measurement objectives to be applied in determining the required monetary amounts that, by their nature, are generally underpinned by either a historical cost or a current value approach, and either an entity-specific or a market-based perspective of value. The nature of financial statement items also varies widely and gives rise to valuation attributes that would be considered relevant from an entity-specific or a market-based perspective, as applicable. The circumstances relevant to the financial statement items, including general economic, regulatory, technological and market conditions, as well as conditions of more specific relevance to the items, may also give rise to relevant valuation factors.
4. Sometimes, accounting estimates can be made based on values for similar or identical items that are observable in similar circumstances, and that reflect the same measurement basis. In other cases, accounting estimates may be made by modelling a value for the item, based on those attributes that would influence the value of the item in the relevant circumstances (valuation attributes), taking into account:
 - The objectives of the measurement basis; and
 - The nature and circumstances of the item.
5. Modelling an accounting estimate may therefore involve determining:
 - The relevant quantitative and qualitative valuation attributes;
 - To the extent relevant attributes are observable, the sources of data that would be appropriate values for those attributes;
 - To the extent relevant attributes are not observable, the types of assumptions that may represent appropriate values for the relevant attributes and the sources of data that would be appropriate to support those assumptions;
 - The method by which such data and assumptions would be used in determining an appropriate value and in developing information about the sensitivity of that value to possible variations in the data and assumptions used; and
 - Where applicable, the nature and extent of any adjustments that may be made to the output from the application of the valuation method, for example to reflect practical limitations of the method not adequately addressed in its conceptual underpinning.

Examples of Circumstances in Which Accounting Estimates May Be Required in Applying Certain Measurement Bases

Historical Cost Measurement Bases

6. Some measurement bases require the use of monetary amounts exchanged or exchangeable for items recorded in the financial statements, in accordance with the terms of transactions that have occurred before the balance sheet date (historical cost). Such amounts may be directly observable (for example, they may be observed in invoices, remittance or payment advices or contract notes or other primary transaction records). When such amounts are not directly observable it may be necessary to estimate the monetary amount that would be exchanged for the item(s). For example, the amounts exchangeable for an item may only be determinable when the outcome of future events or circumstances is known (such as would be the case when part or all of the amount payable for the acquisition of a business depends on the future earnings of the business).

Adjustments and Allocations of Historical Cost Measures

7. Some measurement bases require the use of a historical cost that has been adjusted due to impairment or onerous obligations or that has been allocated between different items or between different periods. The monetary amounts of such adjustments or allocations will often not be directly observable and will need to be estimated.

Impairment

8. The monetary amount of the impairment, if any, of a historical cost measure of an asset at the balance sheet date may not be directly observable, and may depend on future realizations from the use or sale of the item. Even if the impairment of the asset was realized subsequent to the balance sheet date at a monetary amount that was observable, that amount may not reflect the level of impairment at the balance sheet date, as the level of impairment would have been subject to the effects of changes in circumstances between the balance sheet date and the date of realization.

Depreciation or Amortization

9. The depreciation or amortization of an asset's historical cost during its useful life may only be capable of precise allocation to periods before and after the balance sheet date if, for example, both the extent to which the asset's productive capacity has been consumed through productive use up to that date, and the monetary amount attributable to its residual use, are known with certainty. These amounts may not be determinable with certainty until the asset's total productive use has been observed over its useful life and the residual asset has been disposed of. Ordinarily, therefore, neither of these amounts would be directly observable when accounting estimates for depreciation or amortization are required to be used for inclusion in the financial statements during the asset's useful life.

Current Value Measurement Bases

10. Some measurement bases require the use of monetary amounts that reflect information about conditions at the measurement date rather than information based on historical transactions. Such bases may require the use of a market-participant or an entity-specific perspective.

Fair Value

11. Some current value measurement bases require the use of a monetary amount that would have been exchanged for the item if a transaction had occurred between market participants in an active market (fair value) and therefore such an amount, by its nature, cannot be observed directly. However, an estimate of such an amount can often be made based on quoted prices for identical items that are observable in an active market accessible to the entity (level 1 fair value).
12. If not, it may be possible to make an estimate of fair value based on observable inputs other than those used in a level 1 fair value, such as quoted prices for similar items in an active market or quoted prices for identical items in a non-active market or other inputs observed in or corroborated with active markets (e.g., interest rates, yield curves, implied volatilities or credit spreads) (level 2 fair value).
13. Otherwise, an estimate of fair value may have to be made, sometimes using discounted cash flow techniques, based on the best information available in the circumstances, including unobservable inputs to the extent observable inputs are not available, and taking into account all information about market participant assumptions that is reasonably available (level 3 fair value).

Value in Use and Fulfilment Value

14. Some measurement bases require the use of monetary amounts that reflect the present value of the future cash flows that the entity will obtain from using and disposing of an asset (value in use) or will incur in fulfilling its obligations inherent in a liability (fulfilment value). The monetary amounts required by such measurement bases cannot be observed directly but may be estimated using discounted cash flow techniques. In principle, value in use and fulfilment value accounting estimates reflect an entity-specific perspective but some attributes used in making them may be required to reflect a market-participant perspective.

Discounted Cash Flow Techniques

15. Measurement bases that involve the use of discounted cash flow techniques in making accounting estimates generally require attributes such as the following to be addressed:
 - Estimates of the amount and timing of future cash flows arising from the item;
 - Possible variations in the amount and timing of those cash flows, resulting from uncertainty inherent in those cash flows;
 - Time value of money;
 - Price (a risk premium or discount) for bearing the uncertainty inherent in the cash flows; and
 - Other attributes, such as liquidity, that would be taken into account in the circumstances.

Appendix 2

(Ref: Para. 3, 10)

Factors That May be Indicators of Risks of Material Misstatement for Accounting Estimates

1. Paragraph 2 of this ISA indicates that accounting estimates may be subject to or affected by complexity, the need for the use of judgment by management and estimation uncertainty. The extent to which this is the case affects the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor's responses to those assessed risks. Accordingly, these factors are referred to throughout this ISA and this appendix provides additional background information in relation to them.
2. Paragraphs 3 and 10 of this ISA, respectively, introduce these factors and require the auditor to take them, and any other relevant factors, into account in the identification and assessment of the risks of material misstatement related to an accounting estimate. In responding to the assessed risks of material misstatement the auditor is required, when the criteria in paragraph 13(b) and 13(c) of this ISA are met, to perform procedures to obtain sufficient appropriate audit evidence about certain matters, when specified circumstances are applicable, related to each of these factors.

Circumstances Where the Three Factors Are Likely To Be More Prevalent

3. As explained in Appendix 1, the nature of the measurement basis applied and the nature and circumstances of the financial statement item will also influence the extent to which these factors are present and need to be taken into account, when applicable, in:
 - (a) Making an accounting estimate of the required monetary amount;
 - (b) Understanding the sensitivity of the accounting estimate to variation in those factors; and
 - (c) Considering the related disclosures that may be required.
4. Estimates are more likely to be affected by the interrelationship of these three factors, and to a greater extent, when the method involves modelling. Furthermore, the extent to which accounting estimates are subject to or affected by complexity and the need for the use of management judgment is often related closely to the extent to which they are subject to or affected by estimation uncertainty.

Estimation Uncertainty

5. Estimation uncertainty is the inherent uncertainty that makes accounting estimates susceptible to a lack of precision in their measurement. Depending on the nature of the measurement basis applied and on the nature and circumstances of the financial statement item, the monetary amount of the item may be directly observable before the financial statements are finalized or may only be directly observable at a later date or, in some cases, may not be directly observable at all. Estimation uncertainty arises when the required monetary amount for a financial statement item cannot be obtained by observation before the financial statements are finalized and cannot otherwise be determined with precision.
6. Estimation uncertainty may give rise to variation in the possible methods, data sources and types of assumptions that could be used to make the accounting estimate and therefore may

give rise to the need for the use of judgment in making estimates. This in turn may give rise to variation in the possible outcomes of the estimation process (both in the amount of the accounting estimate and in information developed about the sensitivity of that amount to variations in the data or assumptions used). Such variation is relevant in considering how to depict accounting estimates in the financial statements, in accordance with the recognition, measurement, presentation and disclosure requirements of the applicable financial reporting framework.

7. There are inherent limitations in information about relevant valuation attributes, and in available data and assumptions that may be used to support values used for the relevant valuation attributes. As a result, although it is possible to reduce estimation uncertainty by applying available information, it is not possible to reduce estimation uncertainty beyond certain limits. Furthermore, most accounting frameworks acknowledge that the information that should be taken into account may also be limited (and that it is therefore not practical to reduce estimation uncertainty beyond this limit) when the cost of obtaining it would exceed the benefits (the cost constraint). Residual estimation uncertainty therefore reflects what is not practically knowable or is not known about these matters.
8. The extent to which there is residual estimation uncertainty is reflected in the sensitivity of the amount of the accounting estimate to the use of different methods, or to variations in the available data or in the values for the assumptions that could be used, in making the accounting estimate. Although an estimate subject to higher levels of estimation uncertainty may be less precisely measureable than one subject to lower levels, the accounting estimate may still have significant relevance for users of the financial statements if the nature and extent of the estimation uncertainty is appropriately addressed in the financial statements in accordance with the requirements of the applicable financial reporting framework. This is accomplished by appropriately selecting the point estimate to use in the financial statements and appropriately describing the extent, nature and measurement effect of the residual estimation uncertainty. In some cases, estimation uncertainty associated with an accounting estimate may be so great that the recognition criteria in the applicable financial reporting framework are not met and the accounting estimate cannot be recognized in the financial statements, though there may still be relevant disclosure requirements.

Complexity

9. Complexity in making accounting estimates arises when there are multiple valuation attributes and multiple or non-linear relationships between them. Specialized skills or knowledge may, for example, be needed in relation to:
 - Available valuation concepts and techniques that could be used in the context of the measurement basis and objectives or other requirements of the applicable financial reporting framework and how to apply those concepts or techniques;
 - Experience of the underlying valuation attributes that may be relevant given the nature and circumstances of the financial statement items for which accounting estimates are being made; or
 - The availability of appropriate sources of data (including data relevant to the development of appropriate assumptions) from internal sources (including from sources outside the general or subsidiary ledgers) or from external information

sources, or how to address difficulties in obtaining data from such sources or in maintaining its integrity in applying the method.

10. Complexity in applying valuation concepts or techniques may exist when concepts or techniques involve the use of, for example probability-based methods, option pricing formulae or simulation techniques to predict uncertain future outcomes or hypothetical behaviors. Complexity in relation to the method may also exist when multiple sources of data, assumptions or valuation concepts or techniques need to be used in determining the output(s) of the estimation process, including when such items need to be interpreted or processed to obtain derived data or to support the development of assumptions.
11. Complexity in applying valuation concepts or techniques may also relate to data (including data relevant to the development of appropriate assumptions), including when the data is inherently difficult to identify, capture, access or understand. For example:
 - (a) Data may be difficult to obtain when it relates to transactions that are not generally transparent to the public at large. Even when such data is accessible through an external information source, it may be difficult to understand unless the external information source discloses adequate information about the underlying data sources it has used and about any data processing that has been performed.
 - (b) Data reflecting an external information source's views about future conditions or events, which may be relevant in developing support for an assumption, may be difficult to understand without transparency about the rationale and information taken into account in developing those views.
 - (c) Certain types of data may be inherently difficult to understand because they require an understanding of technically complex business or legal concepts, such as may be required to properly understand data that comprises the terms of legal agreements about transactions involving complex financial instruments or insurance products.

Judgment

12. When an accounting estimate is required, the applicable financial reporting framework may not fully specify, for each type of financial statement item and in each possible circumstance, the most appropriate approach to make that accounting estimate. It is also generally not practical for the applicable financial reporting framework to specify all the particular valuation attributes, concepts and techniques that should be used to determine the accounting estimate and related disclosures. As a result, these considerations generally establish a need for the use of judgment by management in making accounting estimate.
13. Judgments are generally also needed to address the inherent information limitations that give rise to estimation uncertainty. In some cases, the level or nature of the inherent limitations in available information may introduce a high degree of subjectivity in making some judgments.
14. The applicable financial reporting framework may provide a basis for making certain judgments, such as explicit or implied objectives relating to measurement, disclosure, the unit of account, or the application of a cost constraint. The applicable financial reporting framework may also highlight the importance of such judgments through requirements for related disclosures.

15. Judgments are generally needed in determining some or all of the following:
- To the extent not specified under the requirements of the applicable financial reporting framework, the appropriate valuation approaches, concepts, techniques and attributes to use in the estimation method, having regard to available knowledge;
 - To the extent valuation attributes are observable but there are various potential sources of data available, the appropriate sources of data to use;
 - To the extent valuation attributes are not observable, the appropriate assumptions or range of assumptions to use, having regard to the limited data available, including, for example, market views;
 - The range of point estimates that could be appropriate to use in the financial statements and the relative likelihood that different parts of the range would be consistent with the objectives of the measurement basis required by the applicable financial reporting framework; and
 - The appropriate amount to use for the accounting estimate, and the appropriate related disclosures to be made, in the financial statements.
16. Management may also need to make judgments about cost constraints, including valuation attributes that need to be taken into account but are not directly observable and about the best information available in the circumstances.
17. Making assumptions about future events or conditions involves the use of judgment, the difficulty of which varies with the extent to which those events or conditions are uncertain. The precision with which it is possible to predict uncertain future events or conditions depends on the extent to which those events or conditions are determinable based on available knowledge, including knowledge of past conditions, events and related outcomes. This also contributes to estimation uncertainty, as described above.
18. Not all features of a future outcome may be uncertain and assumptions will only need to be made in respect of those features of the outcome that are uncertain. For example, in considering the measurement of a possible impairment of a receivable for a sale of goods at the balance sheet date, the amount of the receivable may be unequivocally established and directly observable in the related transaction documents. What may be uncertain is the amount, if any, for loss due to impairment. In this case, assumptions may only be required about the likelihood of loss and about the amount and timing of any such loss.
19. However, in other cases, the amounts of cash flows embodied in the rights relating to an asset may be uncertain (for example, the amount of compensation for loss claimed in an ongoing litigation may be highly uncertain). In those cases, assumptions may have to be made about both the amounts of the underlying rights to cash flows and about potential losses due to impairment depending on the creditworthiness of the party against whom the claim is made.
20. Some uncertain outcomes may be relatively easy to predict with a high level of precision for an individual item. For example, the useful life of a production machine may be easily predicted if sufficient technical information is available about its average useful life. When it is not possible to predict a future outcome, such as an individual's life expectancy based on actuarial assumptions, with reasonable precision, it may still be possible to predict that outcome for a group of individuals with greater precision. Measurement bases may, in some

cases, indicate a portfolio level as the relevant unit of account for measurement purposes, which may reduce inherent estimation uncertainty.

21. In other cases, it may be necessary to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information from which repeating historical patterns of behavior relating to uncertain valuation attributes may be discerned and extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends). These may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways that may also be extrapolated in evaluating future outcomes. Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends. Difficult judgments may be needed about the predictive value of such information.
22. The extent and nature (including the degree of subjectivity involved) of the judgments taken in making the accounting estimates may create opportunity for management bias in making decisions about the course of action that, according to management, is appropriate in making the accounting estimate. When there is also a high level of complexity or a high level of estimation uncertainty, or both, the opportunity for management bias and the ability to conceal it may also be increased. The need to remain professionally skeptical is important when the nature and extent of judgment, complexity and estimation uncertainty is increased.

Agenda Item 2-D

Conforming and Consequential Amendments Arising from Draft Proposed ISA 540 (Revised)

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

Marked from Extant

Matters to Be Communicated

...

Significant Findings from the Audit

16. The auditor shall communicate with those charged with governance: (Ref: Para. A17–A18)
- a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A19–A20)
 - b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A21)
 - c) Unless all of those charged with governance are involved in managing the entity:
 - (i) Significant matters arising during the audit that were discussed, or subject to correspondence, with management; and (Ref: Para. A22)
 - (ii) Written representations the auditor is requesting;
 - d) Circumstances that affect the form and content of the auditor's report, if any; and (Ref: Para. A23–A25)
 - e) Any other significant matters arising during the audit that, in the auditor's professional judgment, are relevant to the oversight of the financial reporting process. (Ref: Para. A26–A28)

Significant Qualitative Aspects of Accounting Practices (Ref: Para. 16(a))

- A19. Financial reporting frameworks ordinarily allow for the entity to make accounting estimates, and judgments about accounting policies and financial statement disclosures, for example, in relation to the use of ~~key~~ assumptions in the development of accounting estimates. ~~for which there is significant measurement uncertainty~~. In addition, law, regulation or financial reporting frameworks may require disclosure of a summary of significant accounting policies or make reference to "critical accounting estimates" or "critical accounting policies and practices" to identify and provide additional information to users about the most difficult, subjective or complex judgments made by management in preparing the financial statements.
- A20. As a result, the auditor's views on the subjective aspects of the financial statements may be particularly relevant to those charged with governance in discharging their responsibilities for

oversight of the financial reporting process. For example, in relation to the matters described in paragraph A19, those charged with governance may be interested in the auditor's evaluation of the adequacy of disclosures of the estimation uncertainty and significant judgments relating to accounting estimates that are affected by, or subject to, estimation, uncertainty, complexity, the need for the use of judgment by management, or other relevant factors.~~auditor's evaluation of the adequacy of disclosures of the estimation uncertainty relating to accounting estimates that give rise to significant risks.~~ Open and constructive communication about significant qualitative aspects of the entity's accounting practices also may include comment on the acceptability of significant accounting practices and the quality of the disclosures. Appendix 2 identifies matters that may be included in this communication.

Appendix 1

(Ref: Para. 3)

Specific Requirements in ISQC 1 and Other ISAs that Refer to Communications with Those Charged With Governance

This appendix identifies paragraphs in ISQC 1¹ and other ISAs that require communication of specific matters with those charged with governance. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* – paragraph 30(a)
- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraphs 21, 38(c)(i) and 40-42
- ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraphs 14, 19 and 22-24
- ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* – paragraph 9
- ISA 450, *Evaluation of Misstatements Identified during the Audit* – paragraphs 12-13
- ISA 505, *External Confirmations* – paragraph 9
- ISA 510, *Initial Audit Engagements—Opening Balances* – paragraph 7
- ISA 540, *Auditing Accounting Estimates and Related Disclosures* – paragraph 22A
- ISA 550, *Related Parties* – paragraph 27
- ISA 560, *Subsequent Events* – paragraphs 7(b)-(c), 10(a), 13(b), 14(a) and 17
- ISA 570 (Revised), *Going Concern* – paragraph 25
- ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* – paragraph 49
- ISA 610 (Revised), *Using the Work of Internal Auditors* – paragraph 18; ISA 610 (Revised 2013), *Using the Work of Internal Auditors* – paragraphs 20 and 31
- ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* – paragraph 46
- ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* – paragraph 17
- ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* – paragraphs 12, 14, 23 and 30
- ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* – paragraph 12
- ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 18
- ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 17—19

¹ ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

Qualitative Aspects of Accounting Practices

The communication required by paragraph 16(a), and discussed in paragraphs A19–A20, may include such matters as:

Accounting Policies

...

Accounting Estimates

- For items for which estimates are significant, issues discussed in ISA 540, including, for example:
 - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.
 - Changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates
 - Whether management's decisions s-relating to the recognition, measurement, presentation and disclosure of ~~to recognize, or to not recognize,~~ the accounting estimates in the financial statements are ~~is~~ in accordance with the applicable financial reporting framework.
 - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates and, if so, why, as well as the outcome of accounting estimates in prior periods.
 - Whether Mmanagement's ~~process-method~~ for making the accounting estimates, ~~(e.g., including when management has used a model.), including whether the selected measurement basis for the accounting estimate~~ is in accordance with the applicable financial reporting framework.
 - Whether the significant data and assumptions used by management in ~~developing-making~~ the accounting estimate are reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework ~~reasonable~~.
 - Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.
 - Risks of material misstatement.
 - Indicators of possible management bias.
 - How management has considered alternative assumptions or outcomes and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
 - The reasonableness of disclosure of estimation uncertainty in the financial statements. The adequacy of disclosure of estimation uncertainty in the financial statements

Conforming Amendments
IAASB Main Agenda (March 2017)
ISA 500, Audit Evidence,

Marked from December 2016 IAASB Board Meeting

Definitions

5. For purposes of the ISA, the following terms have the meanings attributed below:

....

- (cA) External information source – An individual or organization, other than a management's expert, that provides publicly available information ~~and that is~~ used by the entity in preparing the financial statements. (Ref: Para. A1A-A1C)
- (d) Management's expert – An individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements.

....

7. When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence, including information obtained from an external information source. (Ref: Para. A26–A33J)
8. If information to be used as audit evidence has been prepared using the work of a management's expert, the auditor shall, to the extent necessary, having regard to the significance of that expert's work for the auditor's purposes: (Ref: Para. A34–A36)
- (a) Evaluate the competence, capabilities and objectivity of that expert; (Ref: Para. A37–A43)
- (b) Obtain an understanding of the work of that expert; and (Ref: Para. A44–A47)
- (c) Evaluate the appropriateness of that expert's work as audit evidence for the relevant assertion. (Ref: Para. A48)
9. When using information produced by the entity, ~~or an external information source~~, the auditor shall evaluate whether the information is sufficiently reliable for the auditor's purposes, including, as necessary in the circumstances: ~~(Ref: Para. A48A–A48K)~~
- (a) Obtaining audit evidence about the accuracy and completeness of the information; and (Ref: Para. A49–A50)
- (b) Evaluating whether the information is sufficiently precise and detailed for the auditor's purposes. (Ref: Para. A51)

External Information Source (Ref: Para 5(cA))

- A1A. In preparing the financial statements, management may make use of information obtained from an external information source. An important consideration in determining whether an individual or organization is acting as an external information source is whether the individual or organization meets the definition of a management's expert with respect to that information. Indicators that an external organization may be acting as an external information source rather than as a management's expert is used include the following:

- The information is not specifically generated for the entity; and
- The information is generally available to the public.

Whether or not management pays a fee ~~for the information to access information from an external information source does not affect this not relevant in~~ considering determination as to whether information is considered to be whether an individual or organization is acting as from an external information source ~~or from a management's expert.~~

A1B. External information sources may include pricing services, governmental organizations, central banks or recognized stock exchanges. Examples of information that may be obtained from external information sources ~~may~~ include:

- Prices and pricing related data;
- Macro-economic data such as historical and forecast unemployment rates and economic growth rates, or census data;
- Credit history data;
- Industry specific data such as an index of reclamation costs for certain extractive industries or viewership information or ratings used to determine advertising revenue in the entertainment industry; and
- Mortality tables used to determine liabilities in the life insurance and pension sectors.

A1C. Depending on the facts and circumstances, an individual or organization may in respect of any particular set of information, be either an external information source or a management's expert but not both. Professional judgment may be needed to determine whether a specific organization is acting as an external information source or as a management's expert with respect to a particular set of information. For example:

- An external organization may be acting as an external information source by providing with respect to data ~~about~~ real estate prices for a particular geographical region that it makes generally available to the public and that management uses in preparing the financial statements. The same external organization may at the same time ~~also~~ be acting as a management's expert for the same entity in ~~by~~ providing an entity management with a valuation service with respect to ~~for the entity's~~ real estate portfolio.
- Some actuarial organizations publish mortality tables for general use which, when used by an entity, may be ~~is~~ information from an external information source, while the same actuarial organization may be a management's expert when helping management to ~~with~~ calculating the pension liability for several of its ~~complex~~ pension plans.
- An individual or organization may possess expertise in the application of models to estimate the fair value of securities for which there is no observable market. If the individual or organization applies that expertise in making an estimate specifically for the entity and which the entity uses in preparing its financial statements, the individual or organization is a management's expert. If, on the other hand, that individual or organization merely provides price data ~~to the public~~ regarding private transactions to the public, and the entity uses that information in its own estimation methods, the individual or organization is an external information source.

...

External Information Sources

A33A. ~~Obtaining The auditor may obtain~~ an understanding of why management uses an external information source, ~~and, as well as~~ how management ~~considered~~ ensured that the relevance and reliability of the information ~~is sufficiently reliable for use in~~ use in preparing its financial

statements. ~~Through the understanding obtained, the auditor may be able to better understand~~ helps to inform the auditor's consideration of the relevance and determination of what procedures may need to be performed to consider the reliability of the data ~~reliability of that information obtained from the external information source.~~

A33B. Depending on the circumstances, ~~The~~ the following factors ~~may be~~ are important considerations about the relevance and reliability of information obtained from an external information source:

- The ~~reputation~~ nature and authority of the external information source used by the entity in the jurisdiction. For example, a central bank or government statistics office with a legislative mandate to provide industry information to the public is likely to be an authority for certain types of information;
- The ability of management to influence the information ~~received from~~ obtained from the external information sources;
- The competence and ~~reputation~~ capability of the external information source with respect to that particular type of information;
- Past experience of the auditor with the reliability of the information provided by the external information source ~~and its reliability~~;
- When available, information about the methods used in preparing the information, how the methods are being applied including, where applicable, how models have been used in such application, and the controls over the methods;
- The entity's controls over the information obtained from external information sources;
- Whether the information was developed taking into account the applicable financial reporting framework;
- The nature and extent of disclaimers or other restrictive language relating to the information obtained; and
- ~~Whether the external information source prices are considered to be consistent in relation to prices from other known reliable external information sources; and~~
- ~~When available, i~~ Whether information is available regarding ~~to evaluate~~ the appropriateness of ~~valuation~~ techniques, assumptions and inputs applied by the external information sources in developing the information obtained ~~for either the specific security or asset class.~~

A33C. The ability of the auditor to consider the reliability of the information from the external information source may vary significantly depending on the source. In many circumstances, the auditor may not be able to consider the accuracy and completeness of the information received from an external information source as there may be no contractual relationship between the external information source and the entity requiring provision of information, or the external information source may refuse to provide information seen as its intellectual property. For example, when an entity uses a central bank's inflation rate to make an accounting estimate, the auditor is unlikely to be able to consider the bank's data and method other than what is made publicly available by the central bank. In such circumstances, the auditor may, depending on the significance of the information, consider the nature and authority of the source or, the auditor may obtain information from a different external information source, when available.

A33D. The availability of information to understand the methods and assumptions used by the external information source may influence the auditor's ability to consider the nature, timing and extent of

procedures to test management's use of the sources. For example, pricing services often provide information about their methods and assumptions by asset class rather than individual securities. Brokers often provide only limited information about their inputs and assumptions when providing broker indicative quotes for individual securities. ~~The ability of the auditor to assess the reliability of the information from the external information source may vary significantly depending on the type of asset or liability and the information source.~~

A33E. The observability of inputs and complexity of methods used to generate the information from the external information source may also influence the auditor's ability to consider the nature and extent of procedures that the auditor needs to perform to test the reliability of information from that source. ~~For example, when testing the reliability of pricing data from a pricing service, the nature of the procedures needed to test the reliability of pricing data for a corporate bond may be different than for asset backed securities issued with the backing of a governmental agency.~~

A33F. Possible approaches for the auditor to consider the relevance and gathering evidence concerning the reliability of information from external information sources may include one the following or some more combination of the following:

- Obtaining a service auditor's report that covers the controls over the information provided and consider determining, whether the service auditor's report provides sufficient appropriate audit evidence about the effectiveness of the controls.²
- ~~Obtaining and evaluating information provided by external information sources about the controls and processes, valuation techniques, and assumptions.~~
- Performing procedures at the external information source to understand the controls and processes, ~~valuation techniques, and assumption used~~, including procedures to verify the completeness of the information after it is obtained from the external information source.
- ~~Independently developing a point estimate or a range for prices provided by the external information source and comparing whether the results were within a reasonable range of each other.~~
- Testing the controls management has in place to assess the reliability of the information from external information sources.
- Considering whether the information is intended to be used in the manner management is using it.
- When the information received from the external information source relates to security prices, the auditor may be able to obtain an independent price from another external information source or perform substantive analytical procedures.

A48I. ~~When the auditor is having difficulty in gathering evidence concerning the reliability of information from external information sources using the approaches in paragraph A48F, alternative audit procedures may provide evidence about the reliability of information obtained from the external information source. The procedures the auditor may perform depend on the specific facts and circumstances. For example, when the information received from the external information source relates to security prices, the auditor may be able to obtain an independent price from another external pricing source or performing substantive analytical procedures.~~³

² ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

³ ~~Substantive analytical procedures are analytical procedures used as a substantive procedure (ISA 520, *Analytical Procedures*, paragraph 1). A substantive procedure is defined in the ISAs as: 'An audit procedure designed to detect material~~

A33G. For fair value measurement, additional considerations of the relevance and reliability of the information used ~~the auditor may evaluate whether the evidence provided by the external information source is relevant. This~~ may also include ~~determining~~ the following:

- (a) Whether fair values are based on trades of the same instrument or active market quotations;
- (b) When the fair values are based on transactions of comparable assets or liabilities, how those transactions are identified and considered comparable; and
- (c) When there are no transactions either for the asset or liability or comparable assets or liabilities, how the information was developed including whether the inputs developed represent the assumptions that market participants would use when pricing the asset or liability, if applicable; and

~~(d) Whether management has considered alternative prices; or~~

~~(e)~~(d) When the fair value measurement is based on a broker quote, whether the broker quote:

- (i) Is from a market maker who transacts in the same type of financial instrument; ~~and~~
- (ii) Is binding or nonbinding, with more weight placed on quotes based on binding offers; and

~~(iii)~~(iii) Reflects market conditions as of the date of the financial statement.

A33H. In some situations, management and the auditor may use the same external information source, for example, because there is, ~~for example~~, only one provider of certain information. When the information obtained from that external information source is used to make an accounting estimate, the auditor may consider whether using the same external information source as management is appropriate, or whether additional audit evidence is needed. In such cases, additional consideration may need to be given to whether the information from the external information source is accurate and complete. In such cases, the auditor may consider the facts and circumstances in determining whether it is appropriate for the auditor to use the same external information source as management. For example, when the information obtained from the external information source is used to make an accounting estimate, the auditor may consider whether more persuasive audit evidence is needed the higher the assessed risk of material misstatement, is.

A48H. Additional consideration may be given ~~procedures may focus on~~ whether the information from an external information source is accurate and complete. When another external information source is available, this may include the auditor accessing a different external information source from that used by management to compare ~~evaluate with~~ the external information source used by management.

A48J. ~~In some cases, it may not be possible to obtain sufficient appropriate audit evidence. In such cases, ISA 705 (Revised) requires the auditor to modify the opinion in the auditor's report as a result of a scope limitation.~~⁴

misstatements at the assertion level.' An example of a substantive analytical procedure would be multiplying a debt by the contractual interest rate, and comparing the result with the recorded interest expense.

⁴—ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*, paragraph 13

ISA 580, *Written Representations*

Marked from Extant

Appendix 1

(Ref: Para. 2)

List of ISAs Containing Requirements for Written Representations

This appendix identifies paragraphs in other ISAs that require subject-matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* – paragraph 39
- ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements* – paragraph 16
- ISA 450, *Evaluation of Misstatements Identified during the Audit* – paragraph 14
- ISA 501, *Audit Evidence—Specific Considerations for Selected Items* – paragraph 12
- ISA 540 (Revised), *Auditing Accounting Estimates, ~~Including Fair Value Accounting Estimates, and Related Disclosures~~* – paragraph 22
- ISA 550, *Related Parties* – paragraph 26
- ISA 560, *Subsequent Events* – paragraph 9
- ISA 570 (Revised), *Going Concern* – paragraph 16(e)
- ISA 710, *Comparative Information—Corresponding Figures and Comparative Financial Statements* – paragraph 9
- ISA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information* – paragraph 13(c)

Illustrative Representation Letter

The following illustrative letter includes written representations that are required by this and other ISAs in effect for audits of financial statements for periods beginning on or after December 15, 2009. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570¹ to obtain a written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX² for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

We confirm that (, *to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or *give a true and fair view*) in accordance therewith.
- The methods and the significant data and assumptions used in making the accounting estimates and their related disclosures are appropriate~~Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.~~ (ISA 540 (Revised))

Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards. (ISA 550)

Supplement to Agenda Item 2

Comparison of Draft Proposed ISA 540 (Revised) with Extant ISA 540¹

Note: Given the extensive changes to ISA 540, the CAG is being provided with a comparison of the proposed text and the existing ISA 540 text. The column on the left is extracted from extant ISA 540 while the column on the right shows the proposed text of ISA 540 (Revised) as presented in **Agenda Item D.2**.

Extant ISA 540	Draft Proposed ISA 540 (Revised)
<p>Scope of this ISA</p> <p>1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised)² and ISA 330³ and other relevant ISAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.</p>	<p>Scope of this ISA</p> <p>1. This International Standard on Auditing (ISA) deals with the auditor's responsibilities relating to accounting estimates and related disclosures in an audit of financial statements. Specifically, it expands on how ISA 315 (Revised), ISA 330, ISA 500⁴ and other relevant ISAs are to be applied in relation to accounting estimates. It also includes requirements and guidance on misstatements of individual accounting estimates, and indicators of possible management bias.</p>
<p>Nature of Accounting Estimates</p> <p>2. Some financial statement items cannot be measured precisely, but can only be estimated. For purposes of this ISA, such financial statement items are referred to as accounting estimates. The nature and reliability of information available to management to support the making of an accounting estimate varies widely, which thereby affects the degree of estimation uncertainty associated with accounting estimates. The degree of estimation uncertainty affects, in turn, the risks of material misstatement of accounting estimates, including their susceptibility to</p>	<p>Nature of Accounting Estimates</p> <p>2. Many financial statement items are susceptible to an inherent lack of precision in their measurement. In the ISAs, such financial statement items are referred to as accounting estimates. Accounting estimates vary widely in nature, and may be subject to, or affected by, complexity, the need for the use of judgment by management, and estimation uncertainty. The extent to which this is the case affects the auditor's identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor's responses to those assessed risks. (Ref: Para: A1A, Appendix 1, Appendix 2)</p>

¹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment*

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

⁴ ISA 500, *Audit Evidence*

Extant ISA 540	Draft Proposed ISA 540 (Revised)
<p>unintentional or intentional management bias. (Ref: Para. A1–A11)</p> <p>3. The measurement objective of accounting estimates can vary depending on the applicable financial reporting framework and the financial item being reported. The measurement objective for some accounting estimates is to forecast the outcome of one or more transactions, events or conditions giving rise to the need for the accounting estimate. For other accounting estimates, including many fair value accounting estimates, the measurement objective is different, and is expressed in terms of the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as estimated market price for a particular type of asset or liability. For example, the applicable financial reporting framework may require fair value measurement based on an assumed hypothetical current transaction between knowledgeable, willing parties (sometimes referred to as “marketplace participants” or equivalent) in an arm’s length transaction, rather than the settlement of a transaction at some past or future date.</p> <p>4. A difference between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements does not necessarily represent a misstatement of the financial statements. This is particularly the case for fair value accounting estimates, as any observed outcome is invariably affected by events or conditions subsequent to the date at which the measurement is estimated for purposes of the financial statements.</p>	<p>3. Accounting estimates may be more susceptible to a risk of material misstatement when:</p> <p>(a) With respect to complexity, management does not:</p> <p>(i) Apply appropriate specialized skills or knowledge in the selection, design or application of the method used to make the accounting estimate, including when the method involves complex modelling;</p> <p>(ii) Appropriately understand the relevance and reliability of the data used, regardless of whether the data is obtained from internal sources or from external information sources; or</p> <p>(iii) Maintain the integrity of the data used.</p> <p>(b) With respect to the need for the use of judgment management does not:</p> <p>(i) Appropriately take into account available information when selecting methods, assumptions, or data; or</p> <p>(ii) Mitigate the risk of management bias; and</p> <p>(c) With respect to estimation uncertainty, management does not:</p> <p>(i) Take appropriate steps to address estimation uncertainty; or</p> <p>(ii) Select an appropriate management point estimate or make appropriate related disclosures in the financial statements.</p>
	<p>Key Concepts of This ISA</p> <p>3A. This ISA focuses the auditor’s attention on designing and performing further audit procedures (including, where appropriate, tests of controls) responsive to the reasons for the assessment given to the assessed</p>

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	<p>risks of material misstatement, particularly when those reasons include complexity, judgment or estimation uncertainty. This ISA also recognizes that the factors complexity, judgment or estimation uncertainty are interrelated and that there are inherent limitations in reducing estimation uncertainty beyond certain limits.</p> <p>3B. The application of professional skepticism by the auditor is particularly important to the auditor's work relating to accounting estimates. Professional skepticism also is important because there is a particular risk of management bias affecting accounting estimates due to their subjective, potentially complex and uncertain nature, and the possible combined effect of complexity, judgment and estimation uncertainty.</p> <p>4. This ISA requires an overall evaluation of accounting estimates based on the audit procedures performed and the audit evidence obtained. In doing so, the auditor is required to evaluate whether the accounting estimates, and related disclosures, are reasonable. For this purpose, the evaluation of reasonableness involves considerations beyond whether the accounting estimate and related disclosures comply with the requirements of the applicable financial reporting framework. (Ref: Para. A1B–A1C).</p>
<p>Effective Date</p> <p>5. This ISA is effective for audits of financial statements for periods beginning on or after December 15, 2009.</p>	<p>Effective Date</p> <p>5. This ISA is effective for audits of financial statements for periods beginning on or after [TBA].</p>
<p>Objective</p> <p>6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:</p> <p>(a) accounting estimates, including fair value accounting estimates, in the financial statements, whether recognized or disclosed, are reasonable; and</p>	<p>Objective</p> <p>6. The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:</p> <p>(a) Accounting estimates, whether recognized or disclosed in the financial statements; and</p>

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<p>(b) related disclosures in the financial statements are adequate,</p> <p>in the context of the applicable financial reporting framework.</p>	<p>(b) Related disclosures in the financial statements,</p> <p>are reasonable in the context of the applicable financial reporting framework.</p>
<p>Definitions</p> <p>7. For purposes of the ISAs, the following terms have the meanings attributed below:</p> <p>(a) Accounting estimate – An approximation of a monetary amount in the absence of a precise means of measurement. This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation. Where this ISA addresses only accounting estimates involving measurement at fair value, the term “fair value accounting estimates” is used.</p> <p>(b) Auditor’s point estimate or auditor’s range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management’s point estimate.</p> <p>(c) Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.</p> <p>(d) Management bias – A lack of neutrality by management in the preparation of information.</p> <p>(e) Management’s point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.</p> <p>(f) Outcome of an accounting estimate – The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.</p>	<p>Definitions</p> <p>7. For purposes of the ISAs, the following terms have the meanings attributed below:</p> <p>(a) Accounting estimate – A monetary amount, prepared in accordance with the requirements of the applicable financial reporting framework, the measurement of which is subject to estimation uncertainty. (Ref: Para. A11A)</p> <p>(b) Auditor’s point estimate or auditor’s range – An amount, or range of amounts, respectively, developed by the auditor in evaluating management’s point estimate. (Ref: Para. A11B)</p> <p>(c) Estimation uncertainty – The susceptibility of an accounting estimate to an inherent lack of precision in its measurement. (Ref: Para. A11C)</p> <p>(d) Management bias – A lack of neutrality by management in the preparation of information. (Ref: Para. A11D)</p> <p>(e) Management’s point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.</p> <p>(f) Outcome of an accounting estimate – The actual monetary amount that results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by an accounting estimate. (Ref: Para A11E)</p>

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<p>Requirements</p> <p>Risk Assessment Procedures and Related Activities</p> <p>8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity's internal control, as required by ISA 315 (Revised), the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates: (Ref: Para. A12)</p> <ul style="list-style-type: none"> (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures. (Ref: Para. A13–A15) (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16–A21) (c) How management makes the accounting estimates, and an understanding of the data on which they are based, including: (Ref: Para. A22–A23) <ul style="list-style-type: none"> (i) The method, including where applicable the model, used in making the accounting estimate; (Ref: Para. A24–A26) (ii) Relevant controls; (Ref: Para. A27–A28) (iii) Whether management has used an expert; (Ref: Para. A29–A30) 	<p>Requirements</p> <p>Risk Assessment Procedures and Related Activities</p> <p>8. When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including its internal control, as required by ISA 315 (Revised), the auditor shall obtain an understanding of the following: (Ref: Para. A12)</p> <ul style="list-style-type: none"> (a) The requirements of the applicable financial reporting framework relevant to accounting estimates, including the recognition criteria, measurement bases and the related presentation and disclosure requirements. (Ref: Para. A13–A15) (aA) Regulatory factors relevant to accounting estimates. (Ref: Para. A15A–A15C) (aB) The nature of the accounting estimates that the auditor expects to be included in the entity's financial statements. (Ref: Para. A15D–A15E) (b) How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements. In obtaining this understanding, the auditor shall make inquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates. (Ref: Para. A16–A21) (c) How management makes accounting estimates, including: (Ref: Para. A22–A23) <ul style="list-style-type: none"> (i) The methods used, how they are selected or designed, and how they are applied, including the extent to which they involve complex modelling; (Ref: Para. A23A–A26)

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<ul style="list-style-type: none"> (iv) The assumptions underlying the accounting estimates; (Ref: Para. A31–A36) (v) Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and (Ref: Para. A37) (vi) Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. A38) 	<ul style="list-style-type: none"> (ii) The process used to select assumptions, including alternatives considered and how management identifies significant assumptions; (Ref: Para. A26A–A35D) (iiA) The process used to select data, including the source(s) of that data and how management identifies significant data; (Ref: Para. A35E–A35H) (iii) The extent to which management has applied specialized skills or knowledge, including whether a management’s expert has been used; (Ref: Para. A35I–A35J) (iiiA) How the risk of management bias is identified and addressed; (Ref: Para. A35K) (iv) How management has addressed estimation uncertainty; and (Ref: Para. A38) (v) Whether management has addressed the need for a change from the prior period in the methods, assumptions or data used, and if so, the nature of, and reasons for, such changes. (Ref: Para. A38A). (d) Each of the components of internal control as they relate to making accounting estimates. (Ref: Para. A38B–A38P)
<p>9. The auditor shall review the outcome of accounting estimates included in the prior period financial statements, or, where applicable, their subsequent re-estimation for the purpose of the current period. The nature and extent of the auditor’s review takes account of the nature of the accounting estimates, and whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, the review is not intended to call</p>	<p>9. The auditor shall review the outcome or re-estimation of previous accounting estimates to the extent that doing so will assist in identifying and assessing the risks of material misstatement in the current period. The auditor shall take into account the characteristics of the accounting estimates in determining the nature and extent of that review. The review is not intended to call into question, based on new information, judgments about previous accounting estimates that were appropriate based on the information available at the time. (Ref: Para.</p>

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<p>into question the judgments made in the prior periods that were based on information available at the time. (Ref: Para. A39–A44)</p>	<p>A38Q–A44)</p> <p>9A. The auditor shall consider whether specialized skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. (Ref: Para. A44A–A44E)</p>
<p>Identifying and Assessing the Risks of Material Misstatement</p> <p>10. In identifying and assessing the risks of material misstatement, as required by ISA 315 (Revised), the auditor shall evaluate the degree of estimation uncertainty associated with an accounting estimate. (Ref: Para. A45–A46)</p> <p>11. The auditor shall determine whether, in the auditor’s judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks. (Ref: Para. A47–A51)</p>	<p>Identifying and Assessing the Risks of Material Misstatement</p> <p>10. In applying ISA 315 (Revised), the auditor is required to identify and assess the risks of material misstatement, at the financial statement and assertion levels, and to determine whether any of the risks of material misstatement identified are, in the auditor’s judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate, the auditor shall take into account the extent to which the accounting estimate is subject to, or affected by relevant factors, including: (Ref: Para. A44F–A44M)</p> <p>(a) Complexity in making the accounting estimate, including:</p> <p>(i) The extent to which the method used by management involves specialized skills or knowledge, including with respect to the use of a model; and (Ref: Para. A44N–A44P)</p> <p>(ii) The difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data; (Ref: Para. A44Q)</p> <p>(b) The need for the use of judgment by management and the potential for management bias, including with respect to methods, assumptions, and data; and (Ref: Para. A44R–A44T)</p> <p>(c) Estimation uncertainty, including the extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the</p>

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	assumptions and data used. (Ref: Para. A44U–A49C)
<p>Responses to the Assessed Risks of Material Misstatement</p> <p>12. Based on the assessed risks of material misstatement, the auditor shall determine: (Ref: Para. A52)</p> <ul style="list-style-type: none"> (a) Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and (Ref: Para. A53–A56) (b) Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. A57–A58) <p>13. In responding to the assessed risks of material misstatement, as required by ISA 330, the auditor shall undertake one or more of the following, taking account of the nature of the accounting estimate: (Ref: Para. A59–A61)</p> <ul style="list-style-type: none"> (a) Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate. (Ref: Para. A62–A67) (b) Test how management made the accounting estimate and the data on which it is based. In doing so, the auditor 	<p>Responses to the Assessed Risks of Material Misstatement</p> <p>11A. In responding to the assessed risks of material misstatement related to accounting estimates, the auditor shall consider whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures. (Ref: Para. A44A–A44F)</p> <p>13. In applying ISA 330, the auditor is required to design and perform further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. In doing so, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that relevant controls are operating effectively, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. With respect to accounting estimates: (Ref: Para. A57A–A57G)</p> <ul style="list-style-type: none"> (a) If the assessed risk of material misstatement is low, but not because that assessment includes an expectation that relevant controls are operating effectively, the auditor shall consider whether a procedure(s) that addresses management's point estimate at an overall level would provide sufficient appropriate audit evidence regarding the assessed risk of material misstatement in the circumstances. (Ref: Para. A57H) (b) If the assessed risk of material misstatement is low and that assessment includes an expectation that relevant controls are operating effectively, the

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<p>shall evaluate whether: (Ref: Para. A68–A70)</p> <ul style="list-style-type: none"> (i) The method of measurement used is appropriate in the circumstances; and (Ref: Para. A71–A76) (ii) The assumptions used by management are reasonable in light of the measurement objectives of the applicable financial reporting framework. (Ref: Para. A77–A83) <p>(c) Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures. (Ref: Para. A84–A86)</p> <p>(d) Develop a point estimate or a range to evaluate management's point estimate. For this purpose: (Ref: Para. A87–A91)</p> <ul style="list-style-type: none"> (i) If the auditor uses assumptions or methods that differ from management's, the auditor shall obtain an understanding of management's assumptions or methods sufficient to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. (Ref: Para. A92) (ii) If the auditor concludes that it is appropriate to use a range, the auditor shall narrow the range, based on audit evidence available, until all outcomes within the range are considered reasonable. (Ref: Para. A93–A95) <p>14. In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in</p>	<p>auditor's further audit procedures shall include tests of controls to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable. Such procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10. (Ref: Para. A57I)</p> <p>(c) If the assessed risk of material misstatement is not low, the auditor's further audit procedures shall include procedures to obtain audit evidence about the matters in paragraphs 13A–13C, when applicable. Such procedures (whether substantive procedures or tests of controls) shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 10, recognizing that the higher the assessed risk the more persuasive the audit evidence needs to be. (Ref: Para. A57J–A57L)</p> <p><i>Complexity</i></p> <p>13A. In complying with paragraphs 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include complexity, the auditor shall obtain sufficient appropriate audit evidence about the following matters when management uses a complex method (including complex modelling), or when management's method otherwise involves the use of specialized skills or knowledge: (Ref: Para A59A–A59D)</p> <ul style="list-style-type: none"> (a) Whether the method, and significant data and assumptions, are appropriate in the context of the applicable financial reporting framework; (b) Whether significant data is relevant and reliable; (c) Whether management has appropriately understood or interpreted significant

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<p>order to obtain sufficient appropriate audit evidence. (Ref: Para. A96–A101)</p>	<p>data, including with respect to contractual terms; (Ref: Para. A59E)</p> <p>(d) Whether the integrity of significant data and assumptions has been maintained in applying the method; and (Ref: Para. A59F)</p> <p>(e) Whether the calculations are mathematically accurate and are appropriately applied.</p> <p><i>Judgment</i></p> <p>13B. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include the need for the use of judgment by management, the auditor shall obtain sufficient appropriate audit evidence about the following matters:</p> <p>(a) When the accounting estimate involves the use of significant data or assumptions:</p> <p>(i) Whether management’s judgments regarding the selection of the method and the significant data and assumptions: (Ref: Para A59G)</p> <p>a. Are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework; or</p> <p>b. Give rise to indicators of possible management bias;</p> <p>(ii) Whether management’s judgments about changes from previous periods in the method or the significant data or assumptions, are appropriate (Ref: Para. A59H–A59L);</p> <p>(iii) Whether significant assumptions are consistent with each other and with those used in other accounting estimates or areas of the entity’s business activities;</p>

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	<p>(iv) Whether management’s judgments in applying the requirements of the applicable financial reporting framework are appropriate;</p> <p>(b) When relevant to the appropriateness of the significant assumptions or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so (Ref: Para. A59M);</p> <p>(c) When management’s application of the method involves complex modelling, whether judgments made have been applied consistently and whether, when applicable:</p> <p>(i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;</p> <p>(ii) Changes, if any, from the previous period’s model are appropriate in the circumstances; and</p> <p>(iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework. (Ref: Para A59N)</p> <p><i>Estimation Uncertainty</i></p> <p>13C. In complying with paragraph 13(b) or 13(c), when the reasons for the assessment given to the risk of material misstatement include estimation uncertainty, the auditor shall obtain sufficient appropriate audit evidence about the following matters:</p> <p>(a) Whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to: (Ref: Para. A59O)</p> <p>(i) Understand and address the</p>

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	<p>estimation uncertainty, and develop a point estimate that meets the measurement objective of the applicable financial reporting framework; and</p> <p>(ii) Whether:</p> <p>(a) Management's point estimate is reasonable; and (Ref: Para. A59V-A59Z)</p> <p>(b) The disclosures in the financial statements that describe the estimation uncertainty are reasonable. (Ref: Para. A60A–A60B)</p> <p>(b) When, in the auditor's judgment, management has not appropriately addressed the effect of estimation uncertainty, based on the audit evidence obtained, the auditor shall, to the extent possible, develop an auditor's point estimate or range to enable the auditor to evaluate the reasonableness of management's point estimate and the disclosures in the financial statements that describe the estimation uncertainty. (Ref: Para A60C–A60K)</p> <p>(c) If, based on the audit evidence obtained, the auditor concludes that it is not appropriate to determine an auditor's point estimate, but that it is appropriate to develop an auditor's range, the auditor shall only include in that range amounts that: (Ref: Para A60L–A60M)</p> <p>(i) Are supported by the audit evidence; and</p> <p>(ii) The auditor has evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.</p>

Further Substantive Procedures to Respond to Significant Risks

Estimation Uncertainty

15. For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ISA 330, the auditor shall evaluate the following: (Ref: Para. A102)

- (a) How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate. (Ref: Para. A103–A106)
- (b) Whether the significant assumptions used by management are reasonable. (Ref: Para. A107–A109)
- (c) Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. A110)

16. If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. A111–A112)

Recognition and Measurement Criteria

17. For accounting estimates that give rise to significant risks, the auditor shall obtain sufficient appropriate audit evidence about whether:

- (a) Management's decision to recognize, or to not recognize, the accounting

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<p>estimates in the financial statements; and (Ref: Para. A113–A114)</p> <p>(b) The selected measurement basis for the accounting estimates, (Ref: Para. A115)</p> <p>are in accordance with the requirements of the applicable financial reporting framework.</p>	
	<p>Disclosures Related to Accounting Estimates</p> <p>13D. The auditor shall obtain sufficient appropriate audit evidence to evaluate whether the accounting estimates have been appropriately disclosed in accordance with the requirements of the applicable financial reporting framework and: (Ref: Para. A120– A121A)</p> <p>(a) In the case of a fair presentation framework, shall evaluate whether it is necessary for management to provide disclosures beyond those specifically required by the framework to achieve the fair presentation of the financial statements as a whole, or</p> <p>(b) In the case of a compliance framework, shall evaluate whether the disclosures are appropriate for the financial statements not to be misleading.</p>
<p>Evaluating the Reasonableness of the Accounting Estimates, and Determining Misstatements</p> <p>18. The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116–A119)</p>	<p>Overall Evaluation Based on Audit Procedures Performed</p> <p>13E. In applying ISA 330 to the accounting estimates for which the auditor’s further audit procedures address the matters in paragraphs 13A-13C, the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether: (Ref: Para A121B–A121D)</p> <p>(a) The assessments of the risks of material misstatement at the assertion level remain appropriate, including when indicators of possible management bias have been identified; and</p>

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	<p>(b) Sufficient appropriate audit evidence has been obtained; and</p> <p>(c) Management's decisions 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.</p> <p>13F. Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. In making this evaluation, the auditor shall consider all relevant audit evidence obtained whether corroborative or contradictory. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall evaluate the implications for the audit. (Ref: Para. A1B–A1C, A121E–A121H)</p>
<p>Indicators of Possible Management Bias</p> <p>21. The auditor shall review the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias. Indicators of possible management bias do not themselves constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates. (Ref: Para. A124–A125)</p>	<p>Indicators of Possible Management Bias</p> <p>21. The auditor shall evaluate whether judgments and decisions made by management in making the accounting estimates included in the financial statements, even if they are individually reasonable, indicate possible bias on the part of the entity's management. When indicators of possible bias are identified the auditor shall evaluate the implications for the audit. (Ref: Para. A121I–A121N)</p>
<p>Written Representations</p> <p>22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable. (Ref: Para. A126–A127)</p>	<p>Written Representations</p> <p>22. The auditor shall obtain written representations from management and, where appropriate, those charged with governance that they believe the methods and significant data and assumptions used in making the accounting estimates and their related disclosures are appropriate. The auditor shall also consider the need to obtain</p>

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	representations about specific accounting estimates, including in relation to the methods, assumptions, or data used. (Ref: Para. A126–A127)
	<p>Communication with Those Charged With Governance or Management</p> <p>22A. In applying ISA 260 (Revised)⁵ and ISA 265⁶, the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate related to the extent to which the accounting estimates and their related disclosures are affected by, or subject to, estimation uncertainty, complexity, use of judgment by management, or other relevant factors. (Ref: Para. A127A–A127C)</p>
<p>Documentation</p> <p>23. The auditor shall include in the audit documentation:</p> <ul style="list-style-type: none"> (a) The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks; and (b) Indicators of possible management bias, if any. (Ref: Para. A128) 	<p>Documentation</p> <p>23. The audit documentation shall include:</p> <ul style="list-style-type: none"> (a) The basis for the auditor's evaluation of the reasonableness of the accounting estimates and related disclosures; and (b) Indicators of possible management bias, if any, and the auditor's evaluation thereof in forming the auditor's opinion on whether the financial statements as a whole are materially misstated. (Ref: Para. A128)

⁵ ISA 260 (Revised), *Communication with Those Charged with Governance*

⁶ ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

Meeting: IAASB
Meeting Location: Lima, Peru
Meeting Date: March 13–17, 2017

Agenda Item 2

Auditing Accounting Estimates and Related Disclosures

Objective of Agenda Item

1. The objective of this agenda item is to approve the issuance of draft proposed ISA 540 (Revised)¹ for exposure.

ISA 540 Task Force

2. The Task Force comprises the following members:
 - Rich Sharko (Task Force Chair, IAASB Member) (supported by Jamie Shannon, IAASB Technical Advisor)
 - Marc Pickeur (Task Force Co-Chair, IAASB Member)
 - Abhijit Bandyopadhyay (IAASB Member)
 - Marek Grabowski (IAASB Member) (supported by Keith Billing)
 - Ron Salole (IAASB Member)
 - Dora Burzenski, (IAASB Technical Advisor)
 - Jean-Jacques Dussutour (Insurance Regulator)
 - Jean Blascos (Practitioner and former IAASB Member)

Barbara Vanich, who is representing the United States Public Company Accounting Oversight Board, and Claire Stone, who is representing the Basel Committee on Banking Supervision's Accounting Experts Group, are official observers to the Task Force. Emilio Pera, who is a practitioner from Dubai, United Arab Emirates, is a correspondent member to the Task Force.

Activities since January 2017 IAASB Teleconference

3. Since the January 2017 IAASB Teleconference, the Task Force met once physically and three times by teleconference.
4. The Task Force continued its outreach activities. During the March 2017 Board meeting the Task Force will update the Board on its outreach activities, including liaison activities with the Global Public Policy Committee and teleconferences with representative of the Basel Committee on Banking Supervision, the Financial Stability Board, the International Association of Insurance Supervisors, the International Forum of Independent Audit Regulators, and the International Organization of Securities Commissions.

¹ Draft Proposed ISA 540 (Revised), *Accounting Estimates and Related Disclosures*

Material Presented

Agenda Item 2–A	Issues and Task Force Recommendations
Agenda Item 2–B	ISA 540 – Marked from December 2016
Agenda Item 2–C	ISA 540 – Clean
Agenda Item 2–D	Conforming and Consequential Amendments

Action Requested

5. The IAASB is asked to consider the issues and Task Force proposals presented in **Agenda Item 2-A**.
6. The IAASB is asked to consider the changes proposed by the Task Force as shown in **Agenda Item 2-B**, and to approve the issuance of proposed ISA 540 (Revised) for exposure. Members are asked to refer to **Agenda Item 2-C** as this will be used as the basis for the discussion of draft proposed (ISA 540 (Revised)).
7. Written comments from members are welcome. The Task Force would appreciate receiving written comments by Friday, March 10th to allow the time for consideration in advance of the meeting, but in any case by no later than noon (Lima time) Monday, March 13th, 2017.

Agenda Item 4-A

ISA 315 (Revised)¹—Issues and Task Force Recommendations

A draft summary of the IAASB's discussions and decisions at its December 2016 meeting can be found in Appendix II to this paper.

Objective of the IAASB Discussion

The objective of this agenda item is to obtain the Board's views on the ISA 315 (Revised) Task Force's views and recommendations related to various matters described in this paper.

I. Issues Explored by the Task Force and Structure of this Paper

1. The IAASB considered recommendations from the ISA 315 (Revised) Task Force (the Task Force) at its December 2016 meeting related to various matters including the identification of inherent risks, the identification of significant classes of transactions, account balances and disclosures, spectrum of risk, significant risks and understanding internal control. The Task Force Chair noted that issues related to control risk would be addressed at the March 2017 IAASB meeting. A significant aspect of control risk relates to considerations around information technology (IT), which is also an important aspect when obtaining an understanding the entity. The Task Force's initial views and discussions relating to internal control and information technology, as well as various other matters, are set out below.
2. This paper explores issues and Task Force views and recommendations related to the following topics:
 - (a) *Information Technology*—initial discussions about the necessary understanding by the auditor of IT in obtaining the required understanding of the entity and its environment, including the entity's internal control (Section II).
 - (b) *Internal Control: Control Activities Relevant to the Audit*—Further consideration of guidance to assist auditors in identifying control activities relevant to the audit (Section III).
 - (c) *Risk Assessment*—Separate or combined assessment of inherent risk and control risk (Section IV).
 - (d) *Significant Risk*—Exploring a new proposed working definition of significant risk in addition to consequences, impediments and benefits of the proposed direction in clarifying the concept of significant risk (Section V).
 - (e) *Data Analytics*—With input from the IAASB's Data Analytics Working Group (DAWG), exploring how the use of technology, specifically data analytics, is able to support the auditor's risk assessment procedures, including initial discussions on how data analytics could best be incorporated into ISA 315 (Revised) (Section VI).
 - (f) *Professional Skepticism*—Building off of the Professional Skepticism Working Group's (PSWG) discussions with the IAASB at the June, September and December 2016 IAASB meetings,² initial

¹ International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*. References to the ISAs in this paper are to the 2016—2017 IAASB Handbook, a copy of which has been provided as a Supplement to Agenda Item 4.

² The Task Force's initial consideration about professional skepticism has also been informed by the PSWG's Professional Skepticism Matrix presented to the Board for discussion in June 2016 (see [Agenda Item 2-B](#)).

Task Force considerations of possible enhancements to ISA 315 (Revised) to enhance the application of professional skepticism when performing risk assessment procedures during the audit (Section VII).

II. Information Technology

3. Respondents to the IAASB's ISA Implementation Monitoring project noted that as a result of developments in IT (explained further below), the complexity of the information systems used by many entities, and the related risks associated with IT, are not sufficiently emphasized in ISA 315 (Revised). Respondents also highlighted that auditors may not be adequately considering the:
 - (a) Extent to which the entity utilizes IT and the influence this may have on the auditor's identification and assessment of the risks of material misstatement; and
 - (b) Impact of general IT controls on the audit³ and whether the auditor intends to rely on application controls⁴ or not.
4. Accordingly, the Task Force has commenced discussions about the impact of IT on the way that the auditor identifies and assesses the risks of material misstatement, including considerations about what may need to change in ISA 315 (Revised). The following sets out the background to the Task Force's considerations.
5. The Task Force will continue to progress its deliberations about possible changes to ISA 315 (Revised) for discussion with the IAASB at a later meeting, including a more detailed discussion about the impact of general IT controls on the audit and whether the auditor intends to rely on application controls. In exploring how the extent and complexity of the entity's use of IT could be enhanced in the auditor's assessment of the risks of material misstatement, the Task Force is being assisted by a subject-matter expert.

Background—the Need for Modernization of ISA 315 (Revised)

6. IT encompasses the infrastructure and processes to create, process, store, secure, retrieve, study and communicate data and information. It involves the use of a wide range of physical devices such as computers, data and information storage media, networking and communications equipment (such as cables, routers, servers, and Wi-Fi and data network enabled transmitters and receivers) as well as the operating system, data warehousing, database management and application programs that automate the management and communication of data and information.
7. The 'IT revolution' has been a gradual and continual trend toward a broader use of information technology by businesses, governments and society at large. This has been fueled by exponential advances in the speed of data processing and the miniaturization of media for data processing and storage. Also critical has been the subsequent emergence and rapid expansion of wired and wireless digital communications networks, and investment in the capacity and accessibility of the internet including "cloud computing". Taken together with the scale of investment, the application of these advances has been achieved at an ever-reducing cost. While a distinction was once made between "Information Technology" and "Information and Communications Technology" (the latter including voice and video telecommunications technology), in practice these technologies have been merging for some time, with the digitalization of communications and the use of data networks for mobile data distribution and retrieval.

³ ISA 315 (Revised), paragraph A108

⁴ ISA 315 (Revised), paragraph A109

8. As a result, there:

- Are richer and deeper sources of data (whether about an entity themselves or other entities);
- Is much greater capacity to analyze that data to produce information that is more targeted, relevant and reliable; and
- Is more timely accessibility to, and communication of, that data and information.

IT is gradually becoming the medium for all data and information creation, processing, storage and communication. There is a complementary major decline in the use of paper-based records in these processes and a major shift in the skills and expertise needed to manage businesses and other entities, and their IT strategy, architecture and operations.

9. As IT becomes the medium in which nearly all audit evidence is established, it becomes increasingly important to understand an entity's IT system, including how the integrity of the information is maintained. This is the case whether such audit evidence is produced by, or available from sources external to, the audited entity. As a result, the relevance and reliability (appropriateness) of audit evidence is becoming more critically dependent on the IT processes and controls that shape its creation, processing, storage and communication. For example:

- There is an increasing trend for business processes to be “paperless” such that verification of electronic transactions to hard copy accounting records (e.g., shipping documents, price lists) may not be possible. Even if paper documents are prepared these are often converted to digital form.
- Risks of unauthorized access to systems have evolved and increased, with cyber-security a focus for many entities, which increases the importance of the auditor understanding the entity's authentication protocols and how access to financial reporting applications is controlled.
- Methods of data storage and data security have changed significantly due to the ease with which entities may store large volumes of data. This increases the importance of managing data risk including that related to the transfer of data relevant to financial reporting from applications to separate data warehouses.
- Entities are outsourcing IT operations to service providers, which may include outsourcing an entire IT environment to an external hosting service provider, or outsourcing certain aspects, such as moving applications to, or storing data within, “cloud” environments. This means that relevant controls over such applications or data may include controls located outside the entity and for which complementary “user-side” controls in the entity's IT environment may be needed.

Impact of IT on an entity's controls

10. Controls are aspects of one or more of the components of an entity's internal control. They are the policies and procedures that in effect define the internal control process that management and those charged with governance have established to address the identified business risks that threaten the achievement of the entity's objectives with regard to the reliability of financial reporting, the effectiveness and efficiency of operations, and the entity's compliance with applicable laws and regulations.⁵

⁵ Paragraph 4(c) of ISA 315 (Revised) defines internal control as “the process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting., effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term “controls” refers to any aspects of one or more of the components of internal control.”

11. Entities often make extensive use of IT in applying both the policies and procedures that define the financial information preparation processes in the information system relevant to financial reporting and those that define control activities over the financial information preparation processes. Entities also make use of IT in applying the policies and procedures that define other components of the entity's internal control. The use of IT in any of these applications of policies and procedures may be an important consideration for the auditor, when those policies and procedures (controls) are relevant to the auditor's consideration of audit evidence.
12. Controls could be automated controls (e.g., controls embedded in computer programs), manual controls, or a combination. Both manual and automated controls are relevant to the auditor's risk assessment and further audit procedures based thereon.⁶ Manual controls may be independent of IT (referred to hereafter as "manual controls"), may use information produced by IT (referred to hereafter as "IT-dependent manual controls"), or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions.⁷ The nature and extent of controls, whether they are manual or automated vary with the nature and complexity of the entity's use of IT.

The Impact of IT on Identifying and Assessing the Risks of Material Misstatement

13. Developments in IT, including the information systems used by entities to initiate, record, process and report transactions or other financial information, have been significant since ISA 315 (Revised) was issued in 2003, requiring a renewed focus by auditors of the impact of IT on the audit of entities of all sizes.
14. The overall objective and scope of an audit does not differ whether the entity operates in an entirely manual environment, a completely automated environment, or some combination of manual and automated environment. However, an entity's use of IT affects the manner in which financial information is processed, stored and communicated and therefore affects the entity's information system and the manner in which the entity implements internal control relevant to financial reporting.
15. From the auditor's perspective, the entity's use of IT affects:
 - (a) The procedures performed by the auditor in obtaining an understanding of the entity and its environment, including its internal control;
 - (b) The consideration of inherent risk and control risk through which the auditor identifies and assesses the risks of material misstatement;
 - (c) The auditor's design of the nature, timing and extent of further audit procedures; and
 - (d) The performance of those procedures to obtain sufficient appropriate audit evidence.

The auditor's considerations about IT and related work effort is directly impacted by the complexity of the IT system being used. It may range in complexity from 'off the shelf-packages' to highly-customized and highly-integrated systems, including integration with systems and applications external to the entity.

⁶ Paragraph A61 of ISA 315 (Revised)

⁷ From paragraph A62 of ISA 315 (Revised)

Task Force Views

16. As IT has become much more integrated into the information systems and business processes of the entity, the Task Force is of the view that the pervasiveness of IT should be more specifically recognized in the requirements and application material in ISA 315 (Revised):

- With regard to the requirements in paragraphs 11–24 of ISA 315 (Revised), the Task Force plans to consider how IT can be explicitly recognized in the requirements for understanding the entity and its environment, and related internal control, as changes to these paragraphs are made.
- With regard to the application material, the Task Force is of the view that the related application material to 11–24 of ISA 315 (Revised) be substantially enhanced (including as it relates to general IT controls as discussed further below).

In making changes, the Task Force also intends to consider the impact of decentralization of IT (e.g., outsourcing the IT function to third-party service organizations), and the impact of mobile and web-enabled technologies.⁸ Further discussion about some specific aspects where changes have been considered by the Task Force is set out below.

17. The Task Force is also of the view that various terminology changes are needed to reflect developments in technologies and systems that have occurred since ISA 315 (Revised) was first issued (including within Appendix 1 of ISA 315 (Revised)), and the Task Force will continue to explore changes as necessary.

Obtaining an Understanding of Internal Control

Requirements and Guidance in Extant ISA 315 (Revised)

18. Paragraph 12 of ISA 315 (Revised) requires the auditor to obtain an understanding of internal control relevant to the audit. The implementation of this requirement is further explained by detailing the five components of internal control (see footnote 12 of this paper for the five components) and what is required for each of these components (paragraphs 14–24 of ISA 315 (Revised)). The application material associated with Paragraph 12 of ISA 315 (Revised) contains guidance⁹ related to IT considerations in obtaining an understanding of internal control, however, that guidance is not specific to each of the five components of internal control (i.e., relates to obtaining an understanding of internal control in general). Appendix 1 of ISA 315 (Revised) contains internal control component-specific guidance, however it does not contain much guidance relevant to IT considerations within each component of internal control.

Task Force Views

19. Because of the significant impact of IT on internal control, the Task Force is of the view that there are aspects of IT and how the entity uses IT that need to be understood related to each of the five components of internal control, in order for the auditor to effectively identify risks arising from IT that may affect the auditor's identification and assessment of inherent risk or control risk, and ultimately the identification and assessment of the risks of material misstatement. The extent to which the application guidance for to the requirements in paragraphs 14–24 of ISA 315 (Revised) related to understanding each of the components of internal control specifically addresses IT considerations varies.

⁸ In considering the changes, the Task Force will also be mindful of the updates that have been made within the 2013 *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), in particular those relating to general computer controls and information technology controls.

⁹ Paragraphs A61–A67 of ISA 315 (Revised)

20. Although the application material to paragraph 12 of ISA 315 (Revised) is useful to the auditor's overall understanding of risks related to IT and types of controls that might be relevant to the audit, enhancing the application material in relation to each of the five components of internal control for relevant considerations about IT could be improved. The most obvious area for understanding the impact of IT on the entity is the auditor's required understanding of the entity's information system and business processes, which is discussed in further detail below. However, the guidance to the auditor's understanding of the other components of internal control could also be enhanced to include considerations about IT, for example:
- In relation to the control environment—the auditor could consider whether the importance and governance the entity places on IT is commensurate with the nature and size of the entity and its business. This could include understanding the extent of governance over IT functions, the management organizational structure regarding IT and the resources allocated to IT (such as investment in appropriate systems and related maintenance, and employing a sufficient number of appropriately skilled individuals).
 - In relation to the entity's risk assessment process—the auditor could consider the elements of the entity's risk assessment process relating to IT, for example:
 - Risk related to IT in the context of the business (e.g., technological obsolescence);
 - The entity's core business activities (i.e., the extent that an entity's business model and operations rely on IT);
 - Whether the entity's risk assessment process adequately addresses risk factors related to IT, for example, implementation of new IT systems, implementation of an identity and access system, consideration of IT risk related to wire transfers; and
 - Whether there is, in the context of the complexity of the entity's IT systems, adequate focus by the entity on IT or technology risks.
 - In relation to monitoring of controls—the auditor could consider how the entity monitors internal control, in particular when more sophisticated software applications are part of the financial reporting process. For example, monitoring of automated controls and general IT controls is performed in some entities through automation or “real-time monitoring” applications.
21. The Task Force will continue to explore how best the standard can be enhanced to better explain the impacts of IT on each of the components of internal control.

Obtaining an Understanding of the Information System Relevant to Financial Reporting

22. The entity's information system relevant to financial reporting is a part of the entity's broader information system, and is included within the components of internal control relevant to the audit.¹⁰ It includes the policies and procedures (including the related methods and records) that define how information relevant to financial reporting is prepared. This includes the processes for initiating or capturing the underlying data (relating to transactions, other events and conditions), storing and processing that data, reporting related information, securing the integrity of the data and information, and preparing the financial statements (together referred to hereafter as “financial information preparation processes”). It includes related

¹⁰ One of the components of internal control is the information system, including related business processes, relevant to financial reporting and communication (see paragraph 18 of ISA 315 (Revised)).

business processes in which such financial information preparation processes occur and other aspects of the entity's information system relating to information disclosed in the financial statements, whether obtained from within or outside of the general and subsidiary ledgers.

23. Through obtaining an understanding of the information system, including the related business processes, is primarily how an auditor gathers information about the IT applications, databases and other electronic sources (or related IT service providers) that an entity uses to capture events and process transactions relevant to financial reporting. This understanding in turn provides important context to the auditor's identification of control activities relevant to the audit, including general IT control activities.

Requirements and Guidance in Extant ISA 315 (Revised)

24. Paragraph 18 of ISA 315 (Revised) requires the auditor to obtain an understanding of the information system, including the related business processes, relevant to financial reporting. Included in paragraph 18(b) of ISA 315 (Revised) is the requirement for the auditor to obtain an understanding of the procedures, within both IT and manual systems, by which the classes of transactions that are significant to the financial statements are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements. Paragraphs 18 (c), (d) and (e) require an understanding of the related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; how the information system captures events and conditions, other than transactions that are significant to the financial statements; and the financial reporting process used to prepare the entity's financial statements, all of which may also be impacted by the entity's IT system being used. Paragraph 19 requires the auditor to understand how the entity communicates financial reporting roles and responsibilities, which may also be relevant to understanding how IT may be used to accomplish effective communication.
25. Although not specifically emphasized in ISA 315 (Revised), the discussion related to manual and automated elements in paragraphs A61 and A62 of ISA 315 (Revised) in practice applies to paragraph 18 of ISA 315 (Revised). This is in relation to paragraph 18(c) of ISA 315 (Revised), which refers to manual or electronic forms of accounting records, information and specific accounts in the financial statements, paragraph 18(e) of ISA 315 (Revised) which refers to the financial reporting process used to prepare the entity's financial statements, which may include use of IT, ranging from IT systems that may include some automation to systems that are fully automated, and paragraph 18(f) of ISA 315 (Revised) related to understanding controls around journal entries, which likely have some form of automation associated with them.
26. Paragraph 5 of Appendix 1 of ISA 315 (Revised) indicates that an information system "consists of infrastructure (physical and hardware components), software, people, procedures and data and includes reference to the fact that many information systems make extensive use of IT.

Task Force Views

27. As part of understanding the information system including relevant business processes, the auditor gathers information about the IT applications, databases and other electronic sources (or related IT service providers) that an entity uses to capture events and process transactions that are relevant to financial reporting. Beyond identifying the accounting and other applications that are used in the business processes, auditors also typically understand:

- Data—how the entity stores the electronic data produced by the applications or obtained through other means (e.g., application databases, data warehouses or data storage through use of external service providers);
 - System-generated reports—whether separate applications exist that access, use or format this data for financial reporting purposes (e.g., report-writer applications).
28. In obtaining this understanding, the auditor considers the different elements of the entity's IT environment, some of which may be relatively straightforward (in particular where the entity may use "off-the-shelf" packages or applications within which data is stored and may include some functions to create system-generated reports).
29. The Task Force is of the view that appropriate principle-based requirements for the auditor's understanding of IT as it relates to the entity's information system, allowing for scalability from less complex IT systems to those that may require a deeper understanding because of their complexity, would enhance the auditor's understanding of how the information in the financial statements is generated, thus helpful for identifying and assessing the risks of material misstatement. Supporting application material explaining different types of systems and the related work effort could be developed to distinguish the nature and extent of work for complex versus less-complex systems. For example, if outside IT service providers are used, examples of the matters that could be considered by the auditor about the integrity of the information generated could help illustrate what is needed in these situations. The Task Force will continue to explore more specific changes in ISA 315 (Revised).

Identification of General IT Controls Relevant to the Audit

30. The guidance in ISA 315 (Revised) related to general IT controls describes how general IT controls could be effective when they maintain the integrity of information and the security of the data the IT systems processes, but provides little guidance regarding the auditor's determination of how they are relevant to the identification and assessment of risks of material misstatement. Paragraph A108 of ISA 315 (Revised) sets out examples of general IT controls, which are likely to be more relevant in those audits where the IT system is not an "off-the-shelf" system.
31. The Task Force is of the view that in order to promote consistency in the auditor's identification and understanding of general IT controls when they are relevant to the audit, the guidance related to general IT controls in ISA 315 (Revised) needs to be substantially enhanced.
32. As an outcome of the auditor's understanding of the information system, an understanding of the IT environment and the relevant applications is obtained. These are the possible elements of IT for which the auditor may determine that general IT controls relevant to the audit exist. In the Task Force's view, the determination of which applications and other elements of the IT environment the auditor should obtain an understanding of the general IT controls (and are therefore relevant to the audit) is driven by the following factors:
- (a) The nature, extent of change, and level of interaction among the IT elements in the IT environment (i.e., what extent of auditor understanding may be needed based on the complexity of the IT environment);
 - (b) Controls enabled by IT that are included in the auditor's determination of control activities relevant to the audit and the audit strategy decisions taken that influenced their selection; and

- (c) The extent of the auditor's planned use of information produced by the entity's IT applications in performing further audit procedures.
33. In particular, highlighting that general IT controls may still be relevant in less complex environments and when the auditor is not planning to take account of the operating effectiveness of controls, and plans to pursue a primarily substantive strategy, will also help auditors understand the nature and extent of work to be undertaken in respect of general IT controls.
34. The extent of an auditor's effort that is required to identify and obtain and understanding of the general IT controls relevant to the audit depends largely on the complexity of the IT environment. For example, it is likely to involve less effort for a small and medium-sized entity's (SME) environment because auditors of SMEs are more likely to encounter "off-the-shelf" or packaged software where the entity does not have the ability to, or has limited ability to, make changes to the application as there is no access to the source code. In the absence of access to the application source code, program change controls would likely not exist. However, most off-the-shelf software applications do allow for a certain amount of configuration, and the process and controls relevant to changing configurations may be relevant. In all cases, the applications should be secured with authentication (i.e., passwords) and access controls and these would likely be general IT controls relevant to the audit. Accordingly, supporting application material could be developed to address the least complex IT environments for which there may be few general IT controls relevant to the audit. Further enhancements to the application material could then deal with more complex IT environments and how such complexity affects the nature and extent of general IT controls relevant the audit.
35. The Task Force will continue to explore the auditor's consideration of general IT controls and the impact on the nature and extent of work required for the identification and assessment of the risks of material misstatement.

Matter for IAASB Consideration

1. The IAASB is asked for its views on the Task Force's deliberations about the impact of IT on the auditor's risk assessment procedures, and whether there are other specific considerations that the Task Force should explore as it progresses its thinking on possible changes to ISA 315 (Revised).

III. Internal Control—Control Activities Relevant to the Audit

Introduction

36. The Task Force has continued its discussions related to the requirement in ISA 315 (Revised) for the auditor to obtain an understanding of internal control relevant to the audit.¹¹
37. In its previous discussions, the IAASB agreed that the five components of internal control¹² are interlinked and therefore are relevant to the audit, to the extent they exist. Controls exist within each component of internal control and it is the determination of which of those controls are "relevant to the audit" that has been challenging for auditors. The Task Force has started exploring ways to provide further clarification of what is meant by "controls relevant to the audit" for each of the five components of internal control. In

¹¹ Paragraph 12 of ISA 315 (Revised) requires the auditor to "obtain an understanding of internal control relevant to the audit."

¹² (i) Control environment; (ii) the entity's risk assessment process; (iii) the information system, including the related business processes, relevant to financial reporting, and communication; (iv) control activities relevant to the audit and (v) monitoring of controls.

exploring the impact of IT in the auditor's understanding of internal control as set out in **Section II**, the Task Force identified that the relevance of general IT controls to the audit is in part dependent on the control activities relevant to the audit (see paragraph 32). The Task Force discussions since the IAASB's December 2016 meeting have accordingly focused specifically on the words "relevant to the audit" in the control activities component. The Task Force's views on controls relevant to the audit within the other four components of internal control will be discussed at a future IAASB meeting.

38. Paragraph A100 of ISA 315 (Revised) notes that control activities relevant to the audit are those:
- (a) That are considered to be relevant to the audit in the judgement of the auditor (as per paragraph 20 of ISA 315 (Revised));
 - (b) Related to significant risks (as per paragraph 29 of ISA 315 (Revised)); and
 - (c) Related to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence (as per paragraph 30 of ISA 315 (Revised)).

Control Activities Relevant to the Audit—Relevant in the Judgment of the Auditor

39. At the [September 2016 IAASB](#) meeting, the Task Force presented the findings from the ISA Implementation Project for Board discussion that the requirement relating to identification of control activities relevant to the audit can be difficult to apply in practice. It was noted that there are different views regarding the extent to which control activities are relevant to the audit when the auditor plans to take a primarily substantive approach to the audit, in particular in audits of SMEs.
40. Paragraph 20 of ISA 315 (Revised) requires the auditor to "obtain an understanding of control activities relevant to the audit, being those that the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further procedures responsive to assessed risks." The Task Force is of the view that additional guidance should be provided to clarify what those situations may be when the auditor uses judgment to determine control activities that are relevant to the audit, such as when, for example:
- The auditor's understanding of the information system, including the related business processes, indicate that in order to assess the risks of material misstatement an enhanced understanding of control activities is needed, even if the auditor plans to undertake a substantive approach to address the assessed risk.
 - The auditor plans to test controls as part of the response to assessed risks.

Task Force Views¹³

41. Based on the auditor's understanding of the four components of internal control (other than the control activities component), the Task Force is of a view that the auditor gathers a substantial amount of information about the risks of material misstatement (both inherent risk and control risk). Further, the auditor is likely to have formed a view on the audit strategy(ies) that may be most effective to address those risks of material misstatement. At this stage, the auditor may intend to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures. If so, the auditor's judgment of which control activities are relevant to the audit includes identifying the controls that

¹³ The analysis of control activities relevant to the audit in this Section of the paper is without consideration of the relevance of general IT controls to the audit which are subject to separate Task Force consideration as explained in **Section II** of this paper.

the auditor plans to take account of the operating effectiveness thereof. When the auditor intends to take account of the effectiveness of the operating effectiveness of controls, it appears to be clear in practice that those control activities that the auditor intends to take into account are relevant to the audit. Nevertheless, the Task Force is of the view that paragraph A101 of ISA 315 (Revised) should be enhanced to state this more explicitly.

42. If the auditor plans to take a primarily substantive approach, the judgment of which control activities are relevant to the audit is more challenging as highlighted in the ISA Implementation Monitoring findings and accordingly is an issue that the Task Force is specifically exploring.
43. When the auditor intends to take a substantive approach to the audit (whether to all relevant assertions or only certain assertions), the Task Force is of the view that the auditor's judgment of which control activities are relevant to the audit is primarily based on the extent to which the auditor has obtained sufficient information through understanding of the entity and its environment, and the other four components of internal control, to be able to effectively assess the risks of material misstatement at the assertion level, and design substantive procedures in response to assessed risks.
44. In regard to the auditor's determination of whether enough information has been obtained related to risks at the assertion level, the Task Force is of the view that the understanding of the information system, including the related business processes, which includes obtaining an understanding of the flow of transactions from initiation to reporting and the preparation of disclosures in the entity's financial statements (essentially paragraphs 18(a) to 18(f) of ISA 315 (Revised)) has the most influence on this determination. This includes paragraph 18(b) of ISA 315 (Revised) related to understanding the IT aspects of the information system, which as noted previously in this paper, is important when understanding relevant controls.
45. For less complex information systems and business processes, experiences in practice have been that the risks of material misstatement at the assertion level are able to be identified to a sufficient extent after obtaining the auditor's required understanding of the information system. Further, the auditor often has sufficient information from obtaining the required understanding of the information system to determine the nature, timing and extent of the substantive procedures to respond to the risks of material misstatement related to the assertions that are primarily affected by less complex information systems and business processes. The Task Force view is therefore that the auditor may make the judgment that there are no control activities relevant to the audit related to those non-complex information systems and business processes. However, the Task Force is also of the view that the auditor should take into consideration the extent of information produced by the entity that is likely to be used as audit evidence and whether substantively testing such information is most effective to evaluate whether the information is sufficiently reliable for the auditor's purposes. In some cases, the auditor may identify control activities relevant to the audit that address, for example, the accuracy and completeness of certain of the information produced by the entity.
46. As the complexity of the entity, or the information system or a particular business process within an entity, increases (in other words, the identified risk is more likely to be on the upper end of the spectrum of risk), the Task Force is of the view that there is a greater chance that the auditor may identify control activities that are relevant. In addition, there may be regulatory or other expectations regarding the need for auditors to focus on internal controls when performing audits of entity's in certain industries (e.g., the expectations of regulators in the banking and insurance industries) that may result in the auditor needing to obtain an understanding of control activities relevant to the audit regardless of whether the auditor intends to take account of their operating effectiveness.

47. In summary, the Task Force is of the view, that it is likely that the auditor would judge that certain control activities within the information system and business processes are relevant to the audit when:
- The information system and business processes become more complex;
 - The auditor determines they do not have sufficient information to assess the risk of material misstatement at the assertion level to determine the substantive procedures to respond to the risks of material misstatement after understanding the information system; or
 - The auditor determines that substantively testing information produced by the entity will not be an effective strategy to evaluate whether the information is sufficiently reliable for the auditor's purposes.
48. For these control activities judged to be relevant to the audit, the auditor obtains an understanding of them for the purpose of identifying and assessing risks of material misstatement. If the auditor determines that a substantive approach to further audit procedures is to be adopted, the auditor would not be required to test the operating effectiveness of controls.
49. It is therefore possible, especially for entities with non-complex information systems and business processes, that there are no control activities relevant to the audit other than those for which the auditor has determined to test their operating effectiveness and those specifically required by ISA 315 (Revised). Further, for entities with non-complex information systems and business processes for which the auditor takes a primarily substantive approach to the audit, there may be no risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. Therefore, it is possible for audits of these entities that the only control activities that are relevant to the audit may be those that address significant risks, including fraud risks.
50. The Task Force is of the view that more guidance to clarify the matters noted above in ISA 315 (Revised) would be helpful for auditors to understand when control activities may be relevant. Specifically for audits of SMEs, these clarifications are viewed by the Task Force to be particularly beneficial as feedback suggests that it is not clear from the requirements and guidance in extant ISA 315 (Revised) the extent to which control activities are relevant to the audit when the auditor adopts a primarily substantive approach.

Control Activities Relevant to the Audit—Significant Risks

51. As this is a specific requirement in the ISAs,¹⁴ regardless of the complexity of the IT environment, the information system or business processes, the auditor is required to obtain an understanding of the entity's controls, including control activities, relevant to the significant risks. Controls relevant to significant risks includes those relevant to fraud risks, including controls over journal entries. The Task Force has continued its deliberations related to significant risks, discussed in **Section V** of this paper. As the Task Force's exploration of significant risks continues, the requirement to obtain an understanding of control activities relevant to significant risks will also be considered. At this stage however, the Task Force is not proposing any changes to the extant requirement.

Control Activities Relevant to the Audit—Substantive Procedures Alone are Not Sufficient

52. Paragraph 30 of ISA 315 (Revised) notes that controls are relevant to the audit over risks where the auditor judges it not possible or practicable to obtain sufficient appropriate audit evidence by performing

¹⁴ ISA 315 (Revised), paragraph 29

substantive procedures alone, and the auditor is required to obtain an understanding of the relevant controls. However there is little guidance in ISA 315 (Revised) to assist the auditor in making that judgment.

53. The Task Force is of the view that given the increased use of IT, both as part of an entity carrying out its business objectives, as well as related to the entity's information system relevant to financial reporting, that there are many more circumstances in the current environment where paragraph 30 of ISA 315 (Revised) could apply. The Task Force is of the view that providing more context, including examples, in ISA 315 (Revised) describing situations when substantive procedures alone are not likely to be sufficient to obtain sufficient appropriate audit evidence, would enhance the prominence of this requirement and also assist auditor's in applying judgment in identifying these situations.

Matters for IAASB Consideration

2. The IAASB is asked for its views on the matters relating to control activities that are relevant to the audit, specifically:
- (a) When control activities are judged by the auditor to be relevant to the audit (as set out in paragraphs 39–50).
 - (b) Where the auditor judges that it is not possible or practicable to obtain sufficient appropriate audit evidence by performing substantive procedures alone (as set out in paragraphs 52–53).

IV. Risk Assessment

Separate or Combined Assessment of Inherent and Control Risk

54. At the December 2016 IAASB meeting, the Board asked the ISA 315 (Revised) Task Force to further consider whether a combined or separate assessment of inherent risk and control risk would continue to be permitted. This request arose out of the discussion related to introducing a spectrum of inherent risk into ISA 315 (Revised) and whether such introduction would have an effect on the auditor's ability to perform a combined assessment of the risks of material misstatement, as permitted under ISA 200.¹⁵
55. Paragraph A42 of ISA 200 (see Appendix I) describes how the auditor assesses risks of material misstatement through separate or combined assessments of inherent and control risks. ISA 200 then refers to ISA 315 (Revised) for the requirements and guidance for identifying and assessing the risks of material misstatement at the financial statement and assertion levels.
56. Paragraph 25 of ISA 315 (Revised) requires the auditor to *identify* and *assess* the risks of material misstatement to provide a basis for designing and performing further audit procedures. For this purpose, paragraph 26 (a) and (b) of ISA 315 (Revised) sets out that the auditor shall identify risks, then assess the identified risks:
- Paragraph 26(a): Risks are identified through the auditor's understanding of the entity and its environment. This includes identifying relevant controls that relate to the identified risks.

¹⁵ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

- Paragraph 26(b): Identified risks are assessed and the auditor evaluates whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
57. To address the assessed risks identified by the procedures in ISA 315 (Revised), paragraph 7 of ISA 330¹⁶ (see Appendix I) requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level separately for inherent risk and control risk in order to design appropriate audit procedures to be performed to respond to the assessed risks.

Task Force Views

58. Because paragraph 7 of ISA 330 requires the auditor to consider inherent risk and control risk separately (in order to respond appropriately to assessed risk of material misstatement), the Task Force is of the view that the drivers of each element of the risk of material misstatement (i.e., the driver(s) of inherent risk and the driver(s) of control risk), need to be identified separately by the auditor when performing the risk assessment procedures required by ISA 315 (Revised).
59. From a practical standpoint, in understanding the entity and its environment, including internal control, the Task Force is of the view that the auditor gathers information that leads to, and results in, the auditor's separate identification of inherent risks and control risks. Using the separately identified inherent risks and control risks, the auditor has two options under ISA 200 to perform the assessment of the risks of material misstatement. The assessment of inherent risk and control risk may be performed separately to arrive at the assessment of the risk of material misstatement at the assertion level, or the assessment of the risk of material misstatement at the assertion level may be done simultaneously without the separate underlying assessments of inherent risk and control risk. The Task Force therefore views a "combined" assessment of inherent risk and control risk as resulting from the auditor making the assessments of inherent risk and control risk "simultaneously" but with consideration given to both the underlying inherent risks and control risks that have been identified.
60. Accordingly, the Task Force is of the view that possible changes to ISA 315 (Revised) could include:
- Clarification in paragraphs 25 and 26 of ISA 315 (Revised) to:
 - (i) Focus auditors on the separate *identification* of inherent risk and control risk.
 - (ii) Help auditors understand that the *assessment* of the risk of material misstatement at the assertion level may either be done separately or simultaneously, explaining in the application material that the outcome of either approach is intended to result in the same responses to the identified risks. The Task Force is of the view that rather than referring to "separate or combined", the wording be revised to refer to "separate or simultaneous" assessments of inherent and control risk, as they are not 'joined' but rather done at the same time.
 - Moving the guidance in paragraph A42 of ISA 200 to ISA 315 (Revised) to include it in the context of the auditor's risk assessment procedures. The reference to ISA 315 (Revised) in ISA 200¹⁷ would then drive auditors to the requirements and guidance around the assessment of the risk of material misstatement.

¹⁶ ISA 330, *The Auditor's Responses to Assessed Risks*

¹⁷ ISA 200, paragraph A43

61. As the Task Force progresses possible changes, it will continue exploring through its outreach how ‘combined’ risk assessments may be performed in practice to validate its understanding and direction for the possible changes in ISA 315 (Revised) as noted in paragraph 60 above.

Matters for IAASB Consideration

3. Do IAASB members agree with Task Force’s recommendations for possible changes to ISA 315 (Revised) in paragraph 60? IAASB members are asked:
- (a) To share their views as to why they do or do not agree.
 - (b) Whether there are any further implications of these changes not yet considered by the Task Force?

As the Task Force continues to explore the implications of a ‘combined’ risk assessment, Board members are asked to share examples of where a combined risk assessment is performed.

V. Significant Risk

62. Paragraph 4(e) of ISA 315 (Revised) defines significant risk as “an identified and assessed risk of material misstatement that, in the auditor’s judgment, requires special audit consideration.” Paragraph 27 of ISA 315 (Revised) adds further complexity to the determination of significant risks, as it requires the auditor to determine whether any of the risks identified are, in the auditor’s judgment, significant risks and, in making this judgment, the auditor is required to exclude the effects of identified controls related to the risk. The IAASB has already discussed various aspects of challenges and issues identified relating to significant risks.

Summary of IAASB Discussions to Date

63. In its discussions at its September 2016 and December 2016 meetings, the IAASB agreed with the following in relation to significant risks:
- (a) The concept of significant risk should be retained (see further discussion in paragraphs 71–75 below);
 - (b) Significant risk should continue to be a subset of inherent risks (that is, the auditor’s judgment as to which risks are significant risks should continue to exclude the effects of the identified controls related to the risk); however, the Task Force should consider the implications on the auditor’s ability to perform a combined assessment of the risk of material misstatement as contemplated for in paragraph A42 of ISA 200 (see paragraphs 54–61);
 - (c) Auditor judgment in the determination of significant risks¹⁸ should be retained (i.e., not having the ISAs specify issues that should automatically be considered significant risks in every audit (other than what is currently in the ISAs for fraud risks related to management override of controls and revenue recognition));
 - (d) The matters that are addressed in paragraph 28 of ISA 315 (Revised)¹⁹ should be retained as these continue to remain relevant in the auditor exercising judgment as to which risks are significant risks;

¹⁸ ISA 315 (Revised), paragraph 27

¹⁹ Paragraph 29 of ISA 315 (Revised) sets out matters that the auditor considers when judging risks as significant risks.

- (e) The definition of significant risk is circular and the Task Force should explore revising the definition to focus instead on the nature of the risk;
- (f) The qualitative inherent risk factors of complexity, ambiguity, change, uncertainty and susceptibility to fraud would provide a helpful framework for the auditor's understanding and identification of inherent risks, including significant risks, and in evaluating the relative likelihood and magnitude of the risk of material misstatement;
- (g) Reference to the concept of "difficult for management to control" should be considered for inclusion in application material in ISA 315 (Revised) and not within the definition or the requirements related to significant risk in the standard; and
- (h) Significant risks are those inherent risks that are the *highest* on the spectrum of inherent risks.

Further Matters to Consider—From IAASB Discussions

64. At the September 2016 and December 2016 IAASB meetings, the IAASB asked the Task Force to further consider:
- (a) In relation to the Task Force recommendation that the determination of significant risk should be based on the relative likelihood and magnitude of misstatement, and on the nature of the risk in the context of the qualitative inherent risk factors (i.e., a high inherent risk driven by the relative likelihood and magnitude of misstatement and one or a combination of the qualitative inherent risks factors), whether a definition of significant risk that includes these concepts would sufficiently facilitate the auditor's determination of significant risks given these concepts are relevant to the assessment of all inherent risks;
 - (b) Whether those inherent risks that have a low likelihood of misstatement, but if that misstatement were to occur, it would be of high magnitude in terms of its materiality, would be considered to be a significant risk;
 - (c) The relationship between significant classes of transactions, account balances and disclosures, and significant risks;
 - (d) Whether the definition should continue to make reference to "risks of material misstatement," or whether this should be changed to refer to inherent risks;
 - (e) How to operationalize the auditor's consideration of the qualitative inherent risk factors, and the relative likelihood and magnitude of misstatement related to the risk, when identifying significant risks; and
 - (f) Further consider the addition of susceptibility to fraud as a qualitative inherent risk factor as it relates to aspects of both inherent risk and control risk.
65. A description of the qualitative inherent risk factors is set out below (and is consistent with what was presented for IAASB discussion at the IAASB December 2016 meeting) for reference. The Task Force has not considered these factors further since the December 2016 meeting, but will do so in response to

the feedback received as outlined above and include updated views, in particular about the addition of the susceptibility to fraud, at a future IAASB meeting.²⁰

- Complexity: that arises when there are many items or relationships among such items that require integration in applying depiction methods to determine information required by the Financial Reporting Framework (FRF) (e.g., using a complex model to determine a fair value, complex patterns of trading in financial instruments or complex supplier relationships for a retailer).
- Ambiguity: that results from a lack of clarity or a degree of vagueness in exactly what is required by the FRF, resolved by making an election or judgment about the appropriate information to include. Where the matter is more subjective, the judgment may be more susceptible to management bias.
- Change: that results in changes in the information required by the FRF from one point in time to another during or between financial reporting periods – this includes changes in the FRF or in the entity or its business model or in the environment in which the entity operates.
- Uncertainty: that arises from circumstances not within the control of the preparer of the financial information and that affect the determination of information required by the FRF and relate to the past, present or future condition of a transaction or event.
- Susceptibility to Fraud: that results from fraud risk factors and is a quality or state of being susceptible to misappropriation of the entity's assets or fraudulent financial reporting within the context of the FRF, including being susceptible to management override of control.

66. The Task Force has continued to discuss aspects related to significant risks. This paper explores the following, with the Task Force seeking IAASB input on each of these to provide direction for the way forward:

- (a) Proposed 'working definition' of significant risk based on the IAASB direction to date;
- (b) Consequences and impediments of the direction to enhance the concept of significant risk; and
- (c) Whether inherent risks that have low relative likelihood for a material misstatement to occur with high magnitude of potential misstatement should be identified as significant risks (paragraph 64(b) above).

The other matters set out in paragraph 64 above will be discussed with the IAASB at a later meeting.

Proposed Working Definition of Significant Risks

67. As noted in paragraph 63 above, the IAASB has to date agreed on a number of matters related to significant risks. One of the reasons that the concept of significant risk is not consistently applied by auditors is related to its definition. The current definition focuses the auditor on the identification of significant risks related to the nature, timing and extent of the response rather than the nature of the risk.

²⁰ The Task Force is mindful that the qualitative inherent risk factors being considered as set out above are slightly different to those being considered in the proposed changes to ISA 540. The Task Force will continue to monitor the discussions with the Board on the ISA 540 proposals as relevant to determine whether (a) changes may need to be considered in ISA 315 (Revised); (b) the qualitative inherent risk factors in ISA 540 are specific to judgments and estimates and therefore having different factors is appropriate, or (c) further consideration will be needed in revised ISA 540.

68. In its ongoing deliberations regarding possible revisions in ISA 315 (Revised) related to the concept of significant risk, the Task Force has considered the development of a working definition that could help further the Task Force's, and IAASB's, thinking regarding significant risks. The Task Force is not proposing at this time for this working definition to be the revised definition of significant risks. The Task Force has merely attempted to articulate concisely an enhanced concept of significant risks, taking into account the IAASB direction to date, in order to facilitate further discussions with the IAASB regarding whether the Task Force has understood the IAASB's input provided to date related to significant risks and the potential consequences, impediments and benefits to this direction – see paragraphs 71–75).
69. Accordingly, the Task Force's proposed working definition of significant risk, taking into account the IAASB's discussions to date, is as follows:

Significant risks are those inherent risks that the auditor determines to be the highest inherent risks. The highest inherent risks are those with both higher likelihood for material misstatement to occur and higher magnitude of potential misstatement due to their increased susceptibility to material misstatement resulting from one or more of the qualitative inherent risk factors.

70. In developing the working definition, the Task Force has referred to significant risks in the plural (the extant definition of significant risk is in the singular). Using the plural "significant risks" is similar to how key audit matters are addressed in the IAASB's New and Revised Auditor Reporting standards (i.e., key audit matters defined as plural to indicate that they are those matters that are determined to be of most significance in the audit of the financial statements) and that approach would seem to align with the thinking that significant risks are the highest inherent risks.

Matter for IAASB Consideration

4. Does the IAASB agree that the proposed 'working definition' of significant risks captures the discussions with and input from the IAASB to date?

Consequences and Impediments of the Direction to Enhance the Concept of Significant Risk

71. While the IAASB has previously agreed that the concept of significant risk be retained, recent Task Force discussions (particularly in light of the proposed working definition) have included reflecting on the consequences and impediments of retaining the concept of significant risk in order to move forward in developing changes in ISA 315 (Revised). The purpose of these further reflections is to consider whether retaining the concept of significant risk consistent with the current direction will be of benefit. That is, will it enhance audit quality and also address the issues identified in paragraphs 26 and 43–45 in the [ISA 315 \(Revised\) Project Proposal](#)?
72. A question that has been raised consistently both during IAASB discussions and within Task Force discussions is, regardless of the revised definition, what is it that an auditor will do differently to address significant risks in comparison to other risks of material misstatement, in particular other higher inherent risks that might not be concluded to be significant risks? Although most of the audit consequences to identifying significant risks are not within the scope of ISA 315 (Revised), the Task Force agrees that it is appropriate to validate that any revisions to the determination of significant risks in ISA 315 (Revised) will have appropriate and meaningful effects on the procedures to be performed related to these 'special' risks under other ISAs.

73. The following is a summary of the requirements in the ISAs where the concept of significant risks has consequences, and the Task Force views in relation to them assuming that the concept of significant risks is enhanced as previously described:
- (a) Paragraph 29 of ISA 315 (Revised) requires the auditor to obtain an understanding of the entity's controls, including control activities, relevant to significant risks. Paragraph 15 of ISA 330 requires that, if the auditor plans to rely on controls over a significant risk, the auditor shall test those controls in the current period. In line with the IAASB discussions related to significant risks being inherently "difficult to control", the Task Force is of the view that it would be appropriate to retain these requirements.
 - (b) Paragraph 21 of ISA 330 requires the auditor to perform substantive procedures that are specifically responsive to the significant risk. With the implementation of a spectrum of inherent risk in ISA 315 (Revised) that links to paragraph 7 of ISA 330, the Task Force view is that all risks of material misstatement essentially should be subject to substantive procedures that are appropriately responsive. Furthermore, as noted in prior IAASB discussions, there often is not something unique that is performed for significant risks that would not have been performed if the risk had been not designated as "significant." This is a similar challenge to what the ISA 540²¹ Task Force encountered regarding what specific additional procedures might be required for accounting estimates that give rise to significant risks. In those deliberations, the conclusion reached was that it was not so much about the type or nature of the procedure to be performed in response to a significant risk, but rather the extent and timing of the procedure, who performed the procedure, who reviewed the work performed and the persuasiveness of the evidence obtained.
 - (c) Paragraph 21 of ISA 330 also requires that, when the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. The Task Force view is that more persuasive audit evidence should be obtained for significant risks – requiring tests of details may be one method to achieve that. However, this requirement likely needs further consideration, including in conjunction with ISA 540 as it relates to auditing accounting estimates that are significant risks and the effects of data analytics on the audit.
 - (d) Paragraph 8(c) of ISA 230 requires audit documentation specific to significant matters arising during the audit. A significant risk is specified to be a significant matter in paragraph A8 of ISA 230. Paragraph 19 of ISA 220 requires the engagement partner to discuss significant matters with the engagement quality control reviewer. The Task Force views these requirements to be appropriate in relation to significant risks, but not at the expense of appropriate levels of documentation and review for other areas of higher risks of material misstatement.
 - (e) In the new and revised Auditor Reporting Standards, identification of significant risks resulted in:
 - (i) ISA 260 (Revised)²² requiring the auditor to communicate significant risks, identified by the auditor, to those charged with governance. The Task Force is of the view that this communication to those charged with governance should be beneficial to the quality of the discussions between the auditor and those charged with governance.

²¹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

²² ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraphs 15 and A12–A13

- (ii) In accordance with paragraph 9 of ISA 701,²³ the auditor is required to determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor is required to take into account (among other items) areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised). The Task Force view is that communication of significant risks within the auditor's reports when determined to be key audit matters in accordance with ISA 701 is a recent consequence for significant risks that needs to be specifically considered. The Task Force will liaise on an ongoing basis with the IAASB's Auditor Reporting Implementation Working Group to understand any feedback specific to the relationship between significant risks and key audit matters.
74. The Task Force has identified the following impediments should the concept of significant risk be retained in line with the current direction:
- In the context of the proposed spectrum of inherent risks in ISA 315 (Revised), as previously discussed with the IAASB, significant risks will be those inherent risks that are at the highest end of the spectrum of inherent risks, effectively requiring a threshold that will need to be defined. The Task Force is of the view that defining that threshold will be challenging (consistent with the challenges the ISA 540 Task Force has had with defining lower risk in relation to the audit of accounting estimates and related disclosures).
 - The Task Force is of the view that significant auditor judgment will continue to be required when identifying significant risks. This judgment will arise from the determination of the influences of the qualitative inherent risk factors and that a new definition is not going to remove the need for auditor judgment, which means the risk of inconsistent application will not be completely mitigated.
 - By continuing to stress the importance of the identification of significant risks, this may continue to have unintended consequences for some audits, such that other risks of material misstatement not receiving an appropriate amount of auditor focus or attention.
 - In revising the definition of significant risk, it may be difficult to revise the definition to adequately capture the appropriate consideration of fraud risks, i.e., will moving toward a more precise definition of significant risk result in the ability of the nature of fraud risks to be captured by that definition? The Task Force needs to further discuss and develop its thinking in this area but is of the view that capturing fraud risks in a revised definition will be challenging (e.g., are fraud risks higher in likelihood, particularly in all cases).
75. The Task Force is of the view that, in order to continue progressing the revised concept of significant risks, the consequences of the determination of significant risks for the audit (described in paragraph 73 or other consequences that the IAASB believes should be considered by the Task Force) need to be viewed by the IAASB as benefits and those benefits need to be viewed as being great enough to overcome the impediments (as outlined above or others that the IAASB may identify). The Task Force seeks further direction from the IAASB regarding the next steps that the Task Force should consider in progressing revisions to the concept of significant risk.

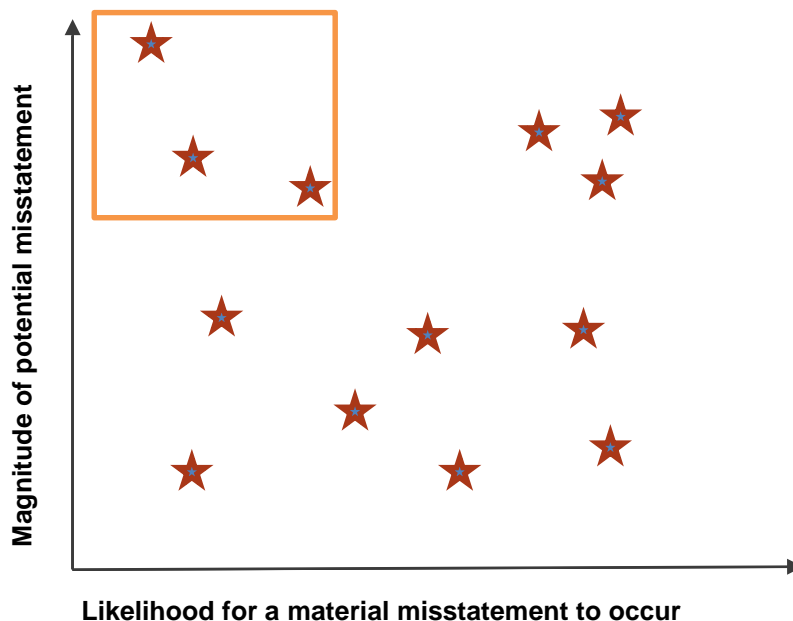
²³ ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*

Matters for IAASB Consideration

5. With input from discussions on significant risk at three IAASB meetings, the Task Force is seeking IAASB input on the appropriate way forward with respect to significant risks:
 - (a) In the context of the consequences and impediments identified by the Task Force in paragraphs 73–74 above, are there other consequences, impediments or benefits not considered by the Task Force if the concept of significant risks is to be retained?
 - (b) Should the Task Force continue in the current direction, progressing with revising the requirements and the definition of significant risks taking into account the input to date from the IAASB, or does the Board recommend consideration for a change in direction on significant risks (e.g., abandon the concept of significant risks, revise requirements etc.)?

Inherent Risks—Low Likelihood for a Material Misstatement to Occur with High Magnitude of Potential Misstatement

76. As noted, the introduction of the concept of a spectrum of inherent risk into ISA 315 (Revised) was supported by the IAASB. The Task Force is of the view that all inherent risks can be visualized on a spectrum of inherent risk such as illustrated below.
77. To respond to IAASB feedback from the December 2016 meeting, the Task Force has further considered whether those inherent risks that are identified as having a low likelihood for a material misstatement to occur, but a high magnitude of potential misstatement should be identified as significant risks (the inherent risks in question being illustrated, for example, in the orange box in the diagram depicting the spectrum of inherent risks).



78. All risks above an acceptably low level, including those risks that have low likelihood for a material misstatement to occur and high magnitude of potential misstatement, require an appropriate response to the assessed risk, with the auditor needing to understand the reasons for the assessed risk of material misstatement in order to design further audit procedures. The Task Force view is that this understanding

would be enhanced as a result of the proposed inclusion of a spectrum of inherent risk in ISA 315 (Revised) and therefore may improve the auditor's responses to all assessed risks of material misstatement at the assertion level.

79. In developing the working definition of significant risks (see paragraphs 67–70 above), it is noted that the Task Force continues to be of the view that only those inherent risks that the auditor considers to be of high likelihood for a material misstatement to occur, and high magnitude of potential misstatement should be identified as significant risks, such that only the highest risks would have specific audit consequences. As a consequence, the Task Force is of the view that those inherent risks with a low likelihood for potential misstatement to occur but a high magnitude of potential misstatement would not be considered a significant risk.

Matter for IAASB Consideration

6. Does the IAASB agree that those inherent risks with a low likelihood for potential misstatement to occur but a high magnitude of potential misstatement should not be considered a significant risk should the concept be retained?

VI. Data Analytics

80. The Task Force notes that ISA 315 (Revised) does not explicitly preclude nor specifically encourage the use of data analytics by the auditor when performing risk assessment procedures. This is an area where practice is rapidly evolving, and the Task Force is mindful that consideration about the impact of data analytics needs to be taken into account as changes to ISA 315 (Revised) are explored.
81. As noted in the Project Proposal, the Task Force, with input from the DAWG, is exploring the impact of using data analytics when gaining the understanding of the entity and its environment in identifying and assessing the risks of material misstatement as required by ISA 315 (Revised).

Input from the Data Analytics Working Group

82. The DAWG provided the Task Force with its initial views on considerations about how data analytics may be used to support the auditor's risk assessment procedures (including in identifying and assessing risks of material misstatement), and where changes to ISA 315 (Revised) could be considered. The DAWG will continue to consider appropriate responses in light of the input from the comment letters received to the Request for Input, [*Exploring the Growing Use of Technology in the Audit, with a Focus on Data Analytics*](#). Accordingly, the DAWG may make additional recommendations for the Task Force's further consideration regarding potential enhancements to ISA 315 (Revised).
83. The input to the Task Force from the DAWG included the following DAWG views on how:
- The use of data analytics in the risk assessment process may enhance the quality of some risk identification and assessment procedures, including describing the anticipated benefits of using data analytics (e.g., a more fulsome analysis of the data than would occur using manual techniques or improved mechanisms for understanding flows of transactions, including identifying alternative paths for transactions).
 - Data analytics can be used to analyze data to assist in undertaking risk identification and assessment procedures (e.g., analytical procedures using visualizations, reperformance and recalculation of routines on data obtained from the entity and predictive modelling techniques).

- It may be difficult to distinguish risk assessment procedures using data analytics from performing procedures to respond to identified risks (i.e., further audit procedures) because of the way procedures are performed when using data analytics (because, for example, different procedures may be performed at the same time).
 - Issues and challenges relating to how procedures using data analytics are documented.
84. The DAWG recommended that the Task Force give further consideration to enhancing ISA 315 (Revised) to:
- (a) Refer to the ability to use data analytics when describing the types of procedures that could be used to perform risk assessment procedures;²⁴
 - (b) Better describe how risk assessment procedures using data analytics can be distinguished from procedures to respond to identified risks of material misstatement so that the appropriate work effort is carried out at each stage; and
 - (c) Address the appropriate documentation of risk assessment procedures performed using data analytics.
85. The Task Force, from its initial consideration of the matters highlighted by the DAWG and subject to further discussion and coordination with the DAWG, agreed in principle that consideration should be given to changes in ISA 315 (Revised) to more directly address the ability of the auditor to make use of data analytics when performing risk assessment procedures.
86. The Task Force's initial view, without pre-judging further information that may be obtained from the DAWG, including based on analysis of responses to the Request for Input, is that no changes to the requirements in ISA 315 (Revised) in relation to performing risk assessment procedures using data analytics are considered necessary. The Task Force, with the exception of one member who is of the view that further consideration of the underlying issues is needed before any decisions are made about how what is known as data analytics can be addressed in the ISAs, including in ISA 315 (Revised), did agree that additional application material would be helpful, including as follows:
- Examples of how to perform risk assessment procedures using data analytics in the application material (e.g., including the application material to paragraph 6 of ISA 315 (Revised) that describes the various types of risk assessment procedures). These examples could include describing typical uses of data analytics, but could also highlight the anticipated benefits of using data analytics over more traditional techniques.
 - Describing how data analytics may be used to understand the flow of transactions and trace transactions through the information system, and also to aid in evaluating the design of controls and determining whether they have been implemented.
 - Emphasize the importance of evaluating whether the data being used is sufficiently reliable for the auditor's purpose (i.e., risk assessment procedures). This may include providing examples of how the auditor might obtain evidence about the completeness and accuracy of the information and how the auditor might evaluate whether the data is sufficiently precise and detailed for the purpose of the auditor's risk assessment procedures.

²⁴ Paragraph 6 of ISA 315 (Revised) describes risk assessment procedures as including inquiries, analytical procedures, observation and inspection.

- Describing how risk assessment procedures using data analytics could be documented (including matters such as the information used and the results of the analysis performed for risk assessment purposes).
 - Providing guidance to help auditors distinguish between risk assessment procedures and further audit procedures when data analytics techniques are applied to the same data set for both purposes, including to:
 - Appropriately document the procedures performed (e.g., how the documentation requirements of ISA 315 (Revised) may be achieved when iterative data analytic techniques are used that involve performing risk assessment procedures and procedures to respond to identified risks of material misstatement concurrently).
 - Determine the appropriate work effort for evaluating whether the data being used is sufficiently reliable for the auditor's purpose (e.g., testing completeness and accuracy) when data analytics are applied to the same data set for both risk assessment purposes and for the purposes of responding to the identified risks of material misstatement.
87. In addition, the DAWG recommended that consideration should be given to developing a “definition” of data analytics for inclusion in the ISAs, noting that this definition would help auditors understand what is meant by using “data analytics” as there are likely varying interpretations about what this term may mean. The Task Force agreed that it would not be appropriate to create a definition of data analytics in isolation in the context of risk assessment procedures. However, an explanation of how the use of data analytics relates to the current terminology in the ISAs related to audit procedures may be helpful.
88. The topic of data analytics has broader implications to the entire audit process, and in particular to audit evidence. The Task Force has the view that further consideration should be given to whether the term “data analytics” is truly representative of the broad range of techniques it is intended to capture and accordingly, whether it may be more appropriate to describe the techniques more precisely and in the context of individual ISAs, or whether this approach should be used in addition to, or instead of, using a defined term. The Task Force notes that such further consideration can be given as this topic is further explored by other IAASB working groups and task forces (including through the DAWG and also by the group that will be assigned to work on the audit evidence project once that project commences). However, regardless of the approach taken to the definition, the Task Force has the view that including examples of using data analytics for risk assessment procedures in the application material of ISA 315 (Revised) as described above, will assist auditors in better understanding how data analytics might be useful in performing risk assessment procedures and may encourage auditors to further consider how and whether using such tools may be beneficial and appropriate.
89. Other matters highlighted by the DAWG, not specifically related to ISA 315 (Revised), included using data analytics to test journal entries, test the operating effectiveness of controls, and to test complete populations of data. The Task Force will share its views on these other matters as relevant with other IAASB task forces and working groups. The Task Force will continue to liaise with the DAWG as it further develops the amendments to ISA 315 (Revised).

Matter for IAASB Consideration

7. The IAASB is asked for its views on:
- (a) The proposed approach to considering possible changes to ISA 315 (Revised) relating to data analytics, specifically the Task Force's initial view that no changes are necessary to the requirements; and
 - (b) Whether there are specific areas where changes need to be considered with regard to the auditor's risk assessment procedures in addition to those noted in paragraphs 86–88 above.

VII. Professional Skepticism

Input from the Professional Skepticism Working Group

84. The Task Force discussed its initial thinking on the topic of professional skepticism and ISA 315 (Revised) at its December 2016 Task Force meeting. A key input in the Task Force's considerations was the matrix prepared by the PSWG that was discussed by the IAASB at its June 2016 meeting ([Agenda Item 2-B of the June 2016 IAASB meeting, referred to hereafter as the PSWG Matrix](#)).

Summary of PSWG's June 2016 Discussions with the IAASB

90. The Board agreed that the exercise of professional skepticism when identifying and assessing risks is critical, given the impact the auditor's identification and assessment of the risks of material misstatement has on the audit.
91. The PSWG noted that the responses to the IAASB's [Invitation to Comment, Enhancing Audit Quality: A Focus on Professional Skepticism, Quality Control and Group Audits](#), highlighted that the ability to effectively exercise professional skepticism is premised upon an appropriate understanding of the entity's business model and related drivers, which assists the auditor in effectively identifying risks of material misstatement.
92. It was highlighted that the engagement team discussion, required by paragraph 10 of ISA 315 (Revised), regarding the susceptibility of the entity's financial statements to material misstatement and the application of the applicable financial reporting framework to the entity's facts and circumstances, is one of the important communications that occurs during the audit between the engagement partner and the engagement team. A lack of appropriate application of professional skepticism during the engagement team discussion may affect the auditor's ability to identify and consider inconsistencies in information obtained while performing risk assessment procedures, as well as the auditor not being appropriately alert for indicators of possible management bias (both intentional and unintentional) when discussing the susceptibility of the entity's financial statements to material misstatement. In both cases, this may lead to improper, incomplete or inaccurate identification and assessment of the risks of material misstatement. In the Board's view, emphasizing the exercise of professional skepticism during the discussion among the engagement team members, including the engagement partner, when performing risk assessment procedures may therefore help mitigate the potential for that outcome.
93. Paragraph 11 of ISA 315 (Revised) sets out matters related to the entity and its environment of which the auditor is required to obtain an understanding. In obtaining this understanding, the auditor is expected to apply professional skepticism in considering the consistency of information gathered or obtained with

other known information and in deciding whether the auditor's understanding is sufficient for the purposes of identifying and assessing the risks of material misstatement. Unresolved inconsistencies in information may indicate either that the auditor has not exercised appropriate professional skepticism in evaluating the information obtained in performing the risk assessment procedures, or in determining whether the information obtained may not be sufficiently reliable for the auditor's purposes.

94. Accordingly, the PSWG suggested that the following approaches may be effective in facilitating the appropriate application of professional skepticism in the performance of risk assessment procedures:
- Strengthening paragraph 10 of ISA 315 (Revised) to reinforce the importance of the exercise of professional skepticism during the engagement team discussion and to remind all engagement team members about the importance of exercising professional skepticism throughout the audit.
 - Providing further guidance to paragraph 10 of ISA 315 (Revised) about matters that may be discussed to help encourage the exercise of professional skepticism during the engagement team discussion, such as identifying inconsistent or contradictory information gathered during the risk assessment procedures.
 - Restructuring paragraph 11 of ISA 315 (Revised) to promote a greater understanding of the business model when understanding the entity and its environment. The suggested restructuring would result in the auditor being required to first obtain an understanding of the entity's business model, objectives, and strategies,²⁵ and then to explicitly consider whether that understanding is consistent with the information and further understanding obtained in addressing the remaining matters within paragraph 11 of ISA 315 (Revised).
 - Requiring the auditor to remain alert to potential management bias (including indicators of management bias) throughout the risk assessment process and not just related to the risk assessment process for specific areas (e.g., accounting estimates under ISA 540).
 - Documentation requirements that:
 - Explicitly require the auditor to consider the nature of the different types of evidence obtained through performing risk assessment procedures and which forms the basis for the auditor's understanding of the entity and its environment.
 - Demonstrate how inconsistent evidence gathered during risk assessment procedures has been dealt with.
 - Demonstrate how potential management bias has been considered and dealt with in planning the engagement.

Risk Assessment and Professional Skepticism in the IAASB's Extant Standards

95. The exercise of professional skepticism by the auditor in performing risk assessment procedures during the audit is currently addressed in ISA 315 (Revised) and other related IAASB standards in the following ways:
- (a) Two references in ISA 315 (Revised) to the exercise of professional skepticism, being in:
 - (i) Paragraph A120 of ISA 315 (Revised) in the context of the auditor obtaining an understanding of the monitoring of controls component of internal control, specifically

²⁵ ISA 315 (Revised), paragraph 11(d)

how communication with the internal audit function (when the entity has such a function) may result in information being brought to the auditor's attention that brings into question the reliability of documents and responses to inquiries to be used as audit evidence; and

- (ii) Paragraph A132 of ISA 315 (Revised) in the context of identifying the risks of material misstatement in the financial statements, it is noted that the auditor exercises professional skepticism in accordance with ISA 200.^{26, 27}
- (b) [The Professional Skepticism Staff Q&A](#) makes reference to professional skepticism in the following ways as it relates to risk assessment:
 - (i) It would be an ideal opportunity to discuss professional skepticism during the discussion among the engagement team regarding the susceptibility of the financial statements to material misstatement as required by paragraph 10 of ISA 315 (Revised).
 - (ii) Professional skepticism is relevant and necessary throughout the audit, in particular in the revision of risk assessment required by paragraph 31 of ISA 315 (Revised).
- (c) Other standards and guidance that provide for the exercise of professional skepticism when identifying circumstances or conditions that increase risks of material misstatement include:
 - (i) Paragraphs 12–14 of ISA 240²⁸ make reference to the requirement in ISA 200 for the auditor to maintain professional skepticism throughout the audit, recognizing that the possibility of material misstatement due to fraud could exist. In addition, it is noted that unless the auditor has reason to believe to the contrary, the auditor may accept records and documents as genuine. However if the auditor identifies conditions during the audit to cause the auditor to believe the documents are not authentic or have been modified, the auditor shall investigate further. It also add that the auditor shall also investigate further if inquiries of management or those charged with governance appear inconsistent.
 - (ii) Paragraph A40 of ISA 540, reference is made to professional skepticism related to the review of prior period accounting estimates and emphasizes that the exercise of professional skepticism assists the auditor in identifying circumstances or conditions that increase the susceptibility in the current year of accounting estimates to, or indicate the presence of, possible management bias and in determining the nature, timing and extent of audit procedures. The review of prior period accounting estimates, however, may only be one indicator of management bias.²⁹
 - (iii) Paragraph 71 of IAPN 1000³⁰ that notes that professional skepticism is necessary to the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. Paragraph 113 of IAPN 1000 explicitly

²⁶ ISA 200, paragraph 15

²⁷ This was an addition to paragraph A132 of ISA 315 (Revised) that arose from the Disclosures Project.

²⁸ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

²⁹ Further changes have been made to encourage the auditor's exercise of professional skepticism when auditing accounting estimates in the proposed revised ISA 540 (see Agenda Item 2).

³⁰ International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

addresses intentional and unintentional management bias and provides examples of what the auditor can look for to determine whether management may be biased.

Task Force Views Regarding Risk Assessment and Professional Skepticism

Overall Task Force View

96. The Task Force is of the view that while it is good and helpful to remind auditors to exercise appropriate professional skepticism, simply increasing references to the application of professional skepticism throughout ISA 315 (Revised) will not result in the desired extent of change in auditor behavior regarding the exercise of professional skepticism in performing risk assessment procedures. In considering the appropriate approach to take to enhance ISA 315 (Revised) to drive the appropriate exercise of professional skepticism when performing risk assessment procedures, the Task Force considered the following options:
- (a) Drafting requirements, similar to the approach that is taken in paragraphs 12–14 of ISA 240, that would explain what an auditor who exercises appropriate professional skepticism would be expected to do in identifying and assessing risks of material misstatement with a view to drive changes in behavior (i.e., require behavior or responses that would be expected to enhance the auditor's application of professional skepticism).
 - (b) Considering how the requirements are structured to encourage a more challenging approach to audit evidence (as opposed to requirements that drive the need for more corroborative evidence).
 - (c) Emphasizing the importance of exercising professional skepticism during the auditor's performance of risk assessment procedures by providing examples or illustrations of actions in the context of the requirements that the auditor may take to achieve the appropriate application of professional skepticism.
97. In progressing revisions to ISA 315 (Revised), the Task Force continues to be of the view (similar to the approach taken in other IAASB projects) that facilitating and promoting the appropriate exercise of professional skepticism through consideration about how the requirements are drafted (as noted in paragraph 96(b) above) and through examples in the application material to illustrate the principles in the requirements (as noted in paragraph 96(c) above) is the preferred approach. Drafting requirements similar to the approach taken in ISA 240 might require too much specificity for the engagement team discussion, and may not result in the desired change in behavior.
98. Accordingly, the Task Force intends to pursue possible changes to ISA 315 (Revised) in relation to the requirements (and related application material) that address the engagement team discussion, the auditor's sources of information for the understanding the entity and its environment, and the auditor's use of qualitative inherent risk factors, each of which is expanded on in the following sections.
99. The Task Force will continue to work with the IAASB PSWG as it continues to consider changes to ISA 315 (Revised).

Engagement Team Discussion—Susceptibility of Financial Statements to Material Misstatement

100. Similar to the views expressed by the PSWG, the Task Force is of the view that the extant requirement in paragraph 10 of ISA 315 (Revised) to conduct the required discussion between the engagement partner

and other key members of the engagement team is key to the exercise of professional skepticism as part of the auditor's risk assessment.

101. The Task Force is of the view that there is scope for improvement in the application material associated with the extant requirement in paragraph 10 of ISA 315 (Revised), with regard to how to promote behavior that reflects the appropriate exercise of professional skepticism by all engagement team members at the engagement team discussion, and which would help encourage a more effective discussion and improved identification of risks of material misstatement. This could include examples of matters for consideration by the engagement team about:

- (a) Threats to the appropriate exercise of professional skepticism, such as dominance of the discussion by the engagement partner and other key engagement team members who may be very familiar with the client, and who may not therefore encourage or facilitate appropriate professional skepticism from others during the engagement team discussion. Responses to those threats may include, for example, having an appropriately experienced and qualified individual (who has had little to no prior experience with the audit of the entity)³¹ attend the engagement team discussion to help address familiarity concerns by challenging the more experienced members of the engagement team. The Task Force noted that this approach may be more effective than brainstorming driven primarily by the engagement partner and other senior members of the engagement team. Another alternative could involve an additional separate team discussion without the engagement partner and other key members of the engagement team so as to not have the views of the more senior members of the team cloud or bias those of others.
- (b) Whether potential risks of material misstatement have also been discussed by the entity.
- (c) Matters that could be discussed to promote behavior that reflects the appropriate exercise of professional skepticism, such as:
 - Has the auditor learned enough about the business and its risks and do the various aspects of what the auditor has learned align with each other?
 - Having identified risks of material misstatement, is the auditor too ready to accept those risks as lower than they actually are?
 - Considering whether sensitivity analysis or stress testing (i.e., considering the impact on the risk assessment of changes in risk factors, including those that could affect the assessment significantly and less significantly) or reverse stress testing (i.e., 'anchoring' to the hypothesis that the risk has materialized and considering what combination of factors would need to occur to give rise to that outcome), would provide appropriate context.
 - Whether sufficient information has been obtained to support the risk assessment in the current year, in particular in recurring engagements where it may just be assumed that the risks in the current year are the same as the previous year.

³¹ Intended to be a person other than the Engagement Quality Control Reviewer.

Source of Auditor's Information in Carrying Out Risk Assessment Procedures

102. In obtaining an understanding of the entity and its environment, as required by paragraph 11 of ISA 315 (Revised), the Task Force is of the view that the entity (or its management) should not be the auditor's sole source of information about the entity and its environment. Further, the Task Force is of the view that the auditor should not "filter" information obtained from sources outside the entity based solely on management's views of its relevance.
103. In the first instance, it will likely be helpful for the auditor to determine whether management has identified the possible risks of material misstatement, and if not, the reasons for not identifying them (being mindful that the auditor does not have, and is not required to have, the same depth of knowledge about the entity and its environment as management, and the auditor may identify risks or have views about them that differ from management). The auditor would also look to other sources when performing risk assessment procedures, with the Task Force having the view that this should be further emphasized in the standard. The following sets out matters that could be included as application material in ISA 315 (Revised) to emphasize that the auditor should not only consider management as its sole source of information, and what some of the other sources of information for the auditor could be:
- Examples of sources that provide information about the entity's industry (e.g., industry journals), general business and market conditions (e.g., financial press), implications of changes to the applicable financial reporting framework (e.g., releases from national standard setters or accounting member body organizations), or views about the entity (e.g., from analysts).
 - Using data analytics to analyze the entity's data, which may in turn reveal information not disclosed to the auditor by management that is relevant to the auditor's understanding of the entity and its environment, including the entity's internal control.
 - Highlighting that multiple sources of information may also assist the auditor in evaluating the potential for management bias, which will further inform the auditor's risk assessment.

Qualitative Inherent Risk Factors

104. The Task Force has discussed the use of qualitative inherent risk factors (see paragraph 65 in **Section V** of this paper) in the auditor's identification of inherent risks and the auditor's identification of significant risks. The Task Force is of the view that the qualitative inherent risk factors would provide a useful reference for the auditor to consider and to provide context for what has been learned from the auditor's risk assessment procedures and facilitate the exercise of professional skepticism, in particular helping the auditor to apply a challenging mindset.
105. The consideration of the qualitative inherent risk factors could aid the auditor in exercising professional skepticism by giving the auditor an objective set of criteria to consider when evaluating the information the auditor has obtained from performing their risk assessment procedures. For example, the auditor could ask themselves whether they have appropriately exercised professional skepticism when considering the impact of complexity on the susceptibility to misstatement. While the qualitative inherent risk factors are listed in paragraph 65 above separately, there may be an element of overlap between some of the factors (e.g., the susceptibility to fraud almost always exists in conjunction with one or more of the other qualitative inherent risk factors and therefore consideration of these factors together may assist the auditor in a more thorough identification of risks).

Documentation

106. The Task Force's objective in considering documentation aspects is to encourage better auditor behavior by having the auditor explain the auditor's thought process and the trail of logic that was followed in making judgements and exercising professional skepticism, and thereby enable the auditor to better demonstrate the exercise of professional skepticism when performing risk assessment procedures.
107. While the Task Force has not reached any conclusions as yet related to documentation, it is of the initial view that the auditor's documentation of the risk assessment process will assist the auditor in evidencing the exercise of professional skepticism (i.e., when the thinking behind the auditor's risk assessment is documented appropriately, the documentation has the ability to evidence the appropriate behavior related to the exercise of professional skepticism). This may include encouraging documentation of the matters the auditor has considered throughout the performance of their risk assessment procedures and creating better linkages between that information and judgments the auditor made in factoring that information into the auditor's risk assessment.

Matter for Board Consideration

8. The IAASB is asked for its views on the matters set out in paragraphs 96–107 above.

VIII. Way Forward

108. The Task Force will continue to work through those aspects of ISA 315 (Revised) that need further consideration that have not yet been discussed with the Board, as well as those aspects where Board feedback has been obtained but where further reflection is needed. The Task Force intends to present a complete depiction of the possible changes to ISA 315 (Revised) identified to date later in 2017.
109. As the Task Force continues exploring possible changes to ISA 315 (Revised), including how to address challenges in applying the standard in a wide variety of circumstances (e.g., how to effectively apply the standard in non-complex entities), further consideration will also be given to how the standard is structured, in particular the section on internal controls.

Appendix I

Extracts of relevant ISA references noted throughout the paper (except those from ISA 315 (Revised), which can be found in the Supplement to Agenda Item 4)

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

Requirements

Professional Skepticism

15. The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated. (Ref: Para. A20–A24)

Application and Other Explanatory Material

Risk of Material Misstatement

- A42. 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.” However, the auditor may make separate or combined assessments of inherent and control risk depending on preferred audit techniques or methodologies and practical considerations. The assessment of the risks of material misstatement may be expressed in quantitative terms, such as in percentages, or in non-quantitative terms. In any case, the need for the auditor to make appropriate risk assessments is more important than the different approaches by which they may be made.
- A43. ISA 315 (Revised) establishes requirements and provides guidance on identifying and assessing the risks of material misstatement at the financial statement and assertion levels.

ISA 220, Quality Control for an Audit of Financial Statements

Requirements

Engagement Quality Control Reviewer

19. For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall:
- (a) Determine that an engagement quality control reviewer has been appointed;
 - (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and
 - (c) Not date the auditor’s report until the completion of the engagement quality control review. (Ref: Para. A23–A25)

ISA 230, Audit Documentation

Requirements

Form, Content and Extent of Audit Documentation

8. The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2–A5, A16–A17)
- (a) The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements; (Ref: Para. A6–A7)
 - (b) The results of the audit procedures performed, and the audit evidence obtained; and
 - (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8–A11)

Application and Other Explanatory Material

Documentation of Significant Matters and Related Significant Professional Judgments (Ref: Para. 8(c))

- A8. Judging the significance of a matter requires an objective analysis of the facts and circumstances. Examples of significant matters include:
- Matters that give rise to significant risks (as defined in ISA 315 (Revised)).
 - Results of audit procedures indicating (a) that the financial statements could be materially misstated, or (b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
 - Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
 - Findings that could result in a modification to the audit opinion or the inclusion of an Emphasis of Matter paragraph in the auditor's report.

ISA 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

Requirements

Professional Skepticism

- 12 In accordance with ISA 200³², the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7–A8)
13. Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
14. Where responses to inquiries of management or those charged with governance are inconsistent, the auditor shall investigate the inconsistencies.

³² ISA 200, paragraph 15

ISA 260, Communication with Those Charged with Governance

Requirements

Planned Scope and Timing of the Audit

15. The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit, which includes communicating about the significant risks identified by the auditor. (Ref: Para. A11–A16)

Application and Other Explanatory Material

Planned Scope and Timing of the Audit (Ref: Para. 15)

A12. Communicating significant risks identified by the auditor helps those charged with governance understand those matters and why they require special audit consideration. The communication about significant risks may assist those charged with governance in fulfilling their responsibility to oversee the financial reporting process.

A13. Matters communicated may include:

- How the auditor plans to address the significant risks of material misstatement, whether due to fraud or error.
- How the auditor plans to address areas of higher assessed risks of material misstatement.
- The auditor's approach to internal control relevant to the audit.
- The application of the concept of materiality in the context of an audit.³³
- The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results, including the use of an auditor's expert.³⁴
- When ISA 701 applies, the auditor's preliminary views about matters that may be areas of significant auditor attention in the audit and therefore may be key audit matters.
- The auditor's planned approach to addressing the implications on the individual statements and the disclosures of any significant changes within the applicable financial reporting framework or in the entity's environment, financial condition or activities.

ISA 330, The Auditor's Responses to Assessed Risks

Requirements

Audit Procedures Responsive to the Assessed Risks of Material Misstatement at the Assertion Level

7. In designing the further audit procedures to be performed, the auditor shall:
- (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including:

³³ ISA 320, *Materiality in Planning and Performing an Audit*

³⁴ See ISA 620, *Using the Work of an Auditor's Expert*.

- (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and
 - (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9–A18)
- (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)

Controls over significant risks

15. If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.

Substantive Procedures Responsive to Significant Risks

21. If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)

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

Application and Other Explanatory Material

Reviewing Prior Period Accounting Estimates (Ref: Para. 9)

- A40. The review of prior period accounting estimates may also assist the auditor, in the current period, in identifying circumstances or conditions that increase the susceptibility of accounting estimates to, or indicate the presence of, possible management bias. The auditor's professional skepticism assists in identifying such circumstances or conditions and in determining the nature, timing and extent of further audit procedures.

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

Requirements

Determining Key Audit Matters

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following: (Ref: Para. A9–A18)
- (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ISA 315 (Revised). (Ref: Para. A19–A22)

- (b) Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)
- (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

IAPN 1000, Special Considerations in Auditing Financial Instruments

Professional Skepticism

71. Professional skepticism is necessary to the critical assessment of audit evidence and assists the auditor in remaining alert for possible indications of management bias. This includes questioning contradictory audit evidence and the reliability of documents, responses to inquiries and other information obtained from management and those charged with governance. It also includes being alert to conditions that may indicate possible misstatement due to error or fraud and considering the sufficiency and appropriateness of audit evidence obtained in light of the circumstances.

Assessing the Risk of Material Misstatement Related to Valuation

113. The susceptibility to management bias, whether intentional or unintentional, increases with the subjectivity of the valuation and the degree of measurement uncertainty. For example, management may tend to ignore observable marketplace assumptions or data and instead use their own internally-developed model if the model yields more favorable results. Even without fraudulent intent, there may be a natural temptation to bias judgments towards the most favorable end of what may be a wide spectrum, rather than the point in the spectrum that might be considered to be most consistent with the applicable financial reporting framework. Changing the valuation technique from period to period without a clear and appropriate reason for doing so may also be an indicator of management bias. Although some form of management bias is inherent in subjective decisions relating to the valuation of financial instruments, when there is intention to mislead, management bias is fraudulent in nature.

Draft summary of the IAASB's discussions at its December 2016 meeting³⁵

ISA 315 (Revised)

Ms. Campbell provided the Board with an overview of **Agenda Item 10-A**, including a summary of the outreach performed by the ISA 315 (Revised) Task Force since the IAASB's September 2016 meeting. Ms. Campbell highlighted that the small- and medium-sized practices (SMP) Committee, in a letter to the IAASB Chairman, expressed support for many of the ISA 315 (Revised) Task Force's recommendations. The SMP Committee did however express concern regarding potential unintended consequences of adding susceptibility to fraud as an additional qualitative inherent risk factor and expressed the view that the concept of "difficult for the entity to control" should not be included in a revised definition of significant risk, noting a preference that this concept be incorporated into application material to assist in explaining the nature of a significant risk.

The Board expressed support for many of the ISA 315 (Revised) Task Force's recommendations included in **Agenda Item 10-A**, including support for efforts to consider the ability of ISA 315 (Revised) to be applied to a wide range of circumstances and scalability with respect to the components of internal control. The Board provided additional matters for the ISA 315 (Revised) Task Force to consider as it progresses the project and in certain areas asked the ISA 315 (Revised) Task Force to consider additional points. Specifically, the Board:

- Asked the ISA 315 (Revised) Task Force to provide clarity as to how some of the proposals would be operationalized, particularly the recommendation to require the auditor to develop an expectation of the classes of transactions, account balances and disclosures expected to be in the entity's financial statements and the consideration of the qualitative inherent risk factors in the identification of significant risks.
- Suggested that the ISA 315 (Revised) Task Force continue to explore the implications of a combined or separate assessment of inherent risk and control risk.
- Recommended outreach with the Public Company Accounting Oversight Board (PCAOB) regarding the proposal to require the auditor to determine significant classes of transactions, account balances and disclosures, and their relevant assertions, to further understand how this is applied in practice.
- Expressed mixed views regarding the ISA 315 (Revised) Task Force's recommendations related to paragraph 18 of ISA 330 to change the requirement for substantive procedures from 'material' classes of transactions, account balances and disclosures to those that are 'significant'. Board members noted variously that the recommendations may result in the purpose of that paragraph being completely different than what is currently intended.
- Expressed mixed views regarding adding the susceptibility to fraud as an additional qualitative inherent risk factor, with some expressing support as being a needed addition, while others noted the risk of confusion regarding the extent of the consideration of controls related to inherent risks (as certain aspects of fraud, such as opportunity, relate to consideration of controls).

³⁵ These draft minutes are still subject to IAASB review and may be subject to further change.

- Asked the ISA 315 (Revised) Task Force to further consider and clarify the interactions between the qualitative inherent risk factors being proposed for ISA 315 (Revised) and the qualitative factors noted within the ISA 540 project.
- In relation to the Task Force recommendation that the determination of significant risk should be based on the relative likelihood and magnitude of misstatement, and on the nature of the risk in the context of the qualitative inherent risk factors (i.e., a high inherent risk driven by the relative likelihood and magnitude of misstatement and one or a combination of the qualitative inherent risks factors), whether a definition of significant risk that includes these concepts would sufficiently facilitate the auditor's determination of significant risks given these concepts are relevant to the assessment of all inherent risks;
- Queried whether those inherent risks that have a low likelihood of misstatement, but if that misstatement were to occur, it would be of high magnitude in terms of its materiality, would be considered to be a significant risk;
- Provided various suggestions for the ISA 315 (Revised) Task Force to consider related to the definition of significant risk, including that:
 - Significant risk should remain a subset of inherent risks; and
 - Reference to “difficult for management to control” be considered for application material and not within the definition or the requirements.

PIOB OBSERVER REMARKS

Prof. Van Hulle commented on the addition of susceptibility to fraud as a qualitative inherent risk factor, noting that from a public interest perspective there is an expectation that the susceptibility of fraud be a part of the auditor's considerations in the identification and assessment of risks.

WAY FORWARD

The ISA 315 (Revised) Task Force will continue to progress possible changes to ISA 315 (Revised), taking into account the Board's feedback. The ISA 315 (Revised) Task Force will bring further matters for discussion to the March 2017 IAASB Consultative Advisory Group (CAG) and IAASB meetings on issues identified in the project proposal that have not yet been discussed such as matters related to information technology, data analytics and professional skepticism in the context of the auditor's risk assessment procedures.

Agenda Item 4 (Supplement)

INTERNATIONAL STANDARD ON AUDITING 315 (REVISED) IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

(Effective for audits of financial statements for periods
ending on or after December 15, 2013)

Introduction

Scope of this ISA

1. This International Standard on Auditing (ISA) deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial statements, through understanding the entity and its environment, including the entity's internal control.

Effective Date

2. This ISA is effective for audits of financial statements for periods ending on or after December 15, 2013.

Objective

3. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Definitions

4. For purposes of the ISA, the following terms have the meanings attributed below:
 - (a) Assertions – Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.
 - (b) Business risk – A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.
 - (c) Internal control – The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
 - (d) Risk assessment procedures – The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the

risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels.

- (e) Significant risk – An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

Requirements

Risk Assessment Procedures and Related Activities

5. The auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Risk assessment procedures by themselves, however, do not provide sufficient appropriate audit evidence on which to base the audit opinion. (Ref: Para. A1–A5)
6. The risk assessment procedures shall include the following:
 - (a) Inquiries of management, of appropriate individuals within the internal audit function (if the function exists), and of others within the entity who in the auditor's judgment may have information that is likely to assist in identifying risks of material misstatement due to fraud or error. (Ref: Para. A6–A13)
 - (b) Analytical procedures. (Ref: Para. A14–A17)
 - (c) Observation and inspection. (Ref: Para. A18)
7. The auditor shall consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement.
8. If the engagement partner has performed other engagements for the entity, the engagement partner shall consider whether information obtained is relevant to identifying risks of material misstatement.
9. Where the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. (Ref: Para. A19–A20)
10. The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A21–A24)

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

11. The auditor shall obtain an understanding of the following:
 - (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A25–A30)
 - (b) The nature of the entity, including:

- (i) its operations;
 - (ii) its ownership and governance structures;
 - (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - (iv) the way that the entity is structured and how it is financed,
- to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A31–A35)
- (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A36)
 - (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A37–A43)
 - (e) The measurement and review of the entity's financial performance. (Ref: Para. A44–A49)

The Entity's Internal Control

12. The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A50–A73)

Nature and Extent of the Understanding of Relevant Controls

13. When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A74–A76)

Components of Internal Control

Control environment

14. The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether:
- (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
 - (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A77–A87)

The entity's risk assessment process

15. The auditor shall obtain an understanding of whether the entity has a process for:
- (a) Identifying business risks relevant to financial reporting objectives;

- (b) Estimating the significance of the risks;
 - (c) Assessing the likelihood of their occurrence; and
 - (d) Deciding about actions to address those risks. (Ref: Para. A88)
16. If the entity has established such a process (referred to hereafter as the “entity’s risk assessment process”), the auditor shall obtain an understanding of it, and the results thereof. If the auditor identifies risks of material misstatement that management failed to identify, the auditor shall evaluate whether there was an underlying risk of a kind that the auditor expects would have been identified by the entity’s risk assessment process. If there is such a risk, the auditor shall obtain an understanding of why that process failed to identify it, and evaluate whether the process is appropriate to its circumstances or determine if there is a significant deficiency in internal control with regard to the entity’s risk assessment process.
17. If the entity has not established such a process or has an ad hoc process, the auditor shall discuss with management whether business risks relevant to financial reporting objectives have been identified and how they have been addressed. The auditor shall evaluate whether the absence of a documented risk assessment process is appropriate in the circumstances, or determine whether it represents a significant deficiency in internal control. (Ref: Para. A89)

The information system, including the related business processes, relevant to financial reporting, and communication

18. The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (Ref: Para. A90–A92 and A95–A96)
- (a) The classes of transactions in the entity’s operations that are significant to the financial statements;
 - (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements;
 - (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form;
 - (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements;
 - (e) The financial reporting process used to prepare the entity’s financial statements, including significant accounting estimates and disclosures; and
 - (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A93–A94)

This understanding of the information system relevant to financial reporting shall include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers.

19. The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A97–A98)
 - (a) Communications between management and those charged with governance; and
 - (b) External communications, such as those with regulatory authorities.

Control activities relevant to the audit

20. The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A99–A106)
21. In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A107–A109)

Monitoring of controls

22. The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control relevant to financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A110–A112)
23. If the entity has an internal audit function,¹ the auditor shall obtain an understanding of the nature of the internal audit function's responsibilities, its organizational status, and the activities performed, or to be performed. (Ref: Para. A113–A120)
24. The auditor shall obtain an understanding of the sources of the information used in the entity's monitoring activities, and the basis upon which management considers the information to be sufficiently reliable for the purpose. (Ref: Para. A121)

Identifying and Assessing the Risks of Material Misstatement

25. The auditor shall identify and assess the risks of material misstatement at:
 - (a) the financial statement level; and (Ref: Para. A122–A125)
 - (b) the assertion level for classes of transactions, account balances, and disclosures, (Ref: Para. A126–A131)to provide a basis for designing and performing further audit procedures.
26. For this purpose, the auditor shall:
 - (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes

¹ ISA 610 (Revised 2013), *Using the Work of Internal Auditors*, paragraph 14(a), defines the term "internal audit function" for purposes of the ISA.

of transactions, account balances, and disclosures (including the quantitative or qualitative aspects of such disclosures) in the financial statements; (Ref: Para. A132–A136)

- (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;
- (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A137–A139)
- (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement could result in a material misstatement. (Ref: Para. A140)

Risks that Require Special Audit Consideration

- 27. As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.
- 28. In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following:
 - (a) Whether the risk is a risk of fraud;
 - (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention;
 - (c) The complexity of transactions;
 - (d) Whether the risk involves significant transactions with related parties;
 - (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and
 - (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A141–A145)
- 29. If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A146–A148)

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

- 30. In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor shall obtain an understanding of them. (Ref: Para. A149–A151)

Revision of Risk Assessment

- 31. The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based

the assessment, the auditor shall revise the assessment and modify the further planned audit procedures accordingly. (Ref: Para. A152)

Documentation

32. The auditor shall include in the audit documentation:²

- (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached;
- (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14–24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and
- (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27–30. (Ref: Para. A153–A156)

Application and Other Explanatory Material

Risk Assessment Procedures and Related Activities (Ref: Para. 5)

A1. Obtaining an understanding of the entity and its environment, including the entity's internal control (referred to hereafter as an "understanding of the entity"), is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit, for example, when:

- Assessing risks of material misstatement of the financial statements;
- Determining materiality in accordance with ISA 320;³
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures;
- Identifying areas relating to amounts or disclosures in the financial statements where special audit consideration may be necessary, for example: related party transactions or management's assessment of the entity's ability to continue as a going concern; or when considering the business purpose of transactions;
- Developing expectations for use when performing analytical procedures;
- Responding to the assessed risks of material misstatement, including designing and performing further audit procedures to obtain sufficient appropriate audit evidence; and

² ISA 230, *Audit Documentation*, paragraphs 8–11, and A6

³ ISA 320, *Materiality in Planning and Performing an Audit*

- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations.
- A2. Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures, and related assertions, and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.
- A3. The auditor uses professional judgment to determine the extent of the understanding required. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to meet the objective stated in this ISA. The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- A4. The risks to be assessed include both those due to error and those due to fraud, and both are covered by this ISA. However, the significance of fraud is such that further requirements and guidance are included in ISA 240 in relation to risk assessment procedures and related activities to obtain information that is used to identify the risks of material misstatement due to fraud.⁴
- A5. Although the auditor is required to perform all the risk assessment procedures described in paragraph 6 in the course of obtaining the required understanding of the entity (see paragraphs 11–24), the auditor is not required to perform all of them for each aspect of that understanding. Other procedures may be performed where the information to be obtained therefrom may be helpful in identifying risks of material misstatement. Examples of such procedures include:
- Reviewing information obtained from external sources such as trade and economic journals; reports by analysts, banks, or rating agencies; or regulatory or financial publications.
 - Making inquiries of the entity's external legal counsel or of valuation experts that the entity has used.

Inquiries of Management, the Internal Audit Function and Others within the Entity (Ref: Para. 6(a))

- A6. Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. Information may also be obtained by the auditor through inquiries with the internal audit function, if the entity has such a function, and others within the entity.
- A7. The auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:
- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared. ISA 260 (Revised)⁵ identifies the importance of effective two-way communication in assisting the auditor to obtain information from those charged with governance in this regard.

⁴ ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraphs 12–24

⁵ ISA 260 (Revised), *Communication with Those Charged with Governance*, paragraph 4(b)

- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
 - Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
 - Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.
 - Inquiries directed to the risk management function (or those performing such roles) may provide information about operational and regulatory risks that may affect financial reporting.
 - Inquiries directed to information systems personnel may provide information about system changes, system or control failures, or other information system-related risks.
- A8. As obtaining an understanding of the entity and its environment is a continual, dynamic process, the auditor's inquiries may occur throughout the audit engagement.

Inquiries of the Internal Audit Function

- A9. If an entity has an internal audit function, inquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels. In performing its work, the internal audit function is likely to have obtained insight into the entity's operations and business risks, and may have findings based on its work, such as identified control deficiencies or risks, that may provide valuable input into the auditor's understanding of the entity, the auditor's risk assessments or other aspects of the audit. The auditor's inquiries are therefore made whether or not the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed.⁶ Inquiries of particular relevance may be about matters the internal audit function has raised with those charged with governance and the outcomes of the function's own risk assessment process.
- A10. If, based on responses to the auditor's inquiries, it appears that there are findings that may be relevant to the entity's financial reporting and the audit, the auditor may consider it appropriate to read related reports of the internal audit function. Examples of reports of the internal audit function that may be relevant include the function's strategy and planning documents and reports that have been prepared for management or those charged with governance describing the findings of the internal audit function's examinations.
- A11. In addition, in accordance with ISA 240,⁷ if the internal audit function provides information to the auditor regarding any actual, suspected or alleged fraud, the auditor takes this into account in the auditor's identification of risk of material misstatement due to fraud.

⁶ The relevant requirements are contained in ISA 610 (Revised 2013).

⁷ ISA 240, paragraph 19

- A12. Appropriate individuals within the internal audit function with whom inquiries are made are those who, in the auditor's judgment, have the appropriate knowledge, experience and authority, such as the chief internal audit executive or, depending on the circumstances, other personnel within the function. The auditor may also consider it appropriate to have periodic meetings with these individuals.

Considerations specific to public sector entities (Ref: Para 6(a))

- A13. Auditors of public sector entities often have additional responsibilities with regard to internal control and compliance with applicable laws and regulations. Inquiries of appropriate individuals in the internal audit function can assist the auditors in identifying the risk of material noncompliance with applicable laws and regulations and the risk of deficiencies in internal control over financial reporting.

Analytical Procedures (Ref: Para. 6(b))

- A14. Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks. Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- A15. Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.
- A16. However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures.

Considerations Specific to Smaller Entities

- A17. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances, although the auditor may be able to perform limited analytical procedures for purposes of planning the audit or obtain some information through inquiry, the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity's financial statements is available.

Observation and Inspection (Ref: Para. 6(c))

- A18. Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following:
- The entity's operations.
 - Documents (such as business plans and strategies), records, and internal control manuals.

- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Information Obtained in Prior Periods (Ref: Para. 9)

A19. The auditor's previous experience with the entity and audit procedures performed in previous audits may provide the auditor with information about such matters as:

- Past misstatements and whether they were corrected on a timely basis.
- The nature of the entity and its environment, and the entity's internal control (including deficiencies in internal control).
- Significant changes that the entity or its operations may have undergone since the prior financial period, which may assist the auditor in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.
- Those particular types of transactions and other events or account balances (and related disclosures) where the auditor experienced difficulty in performing the necessary audit procedures, for example, due to their complexity.

A20. The auditor is required to determine whether information obtained in prior periods remains relevant, if the auditor intends to use that information for the purposes of the current audit. This is because changes in the control environment, for example, may affect the relevance of information obtained in the prior year. To determine whether changes have occurred that may affect the relevance of such information, the auditor may make inquiries and perform other appropriate audit procedures, such as walk-throughs of relevant systems.

Discussion among the Engagement Team (Ref: Para. 10)

A21. The discussion among the engagement team about the susceptibility of the entity's financial statements to material misstatement:

- Provides an opportunity for more experienced engagement team members, including the engagement partner, to share their insights based on their knowledge of the entity.
- Allows the engagement team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement due to fraud or error.
- Assists the engagement team members to gain a better understanding of the potential for material misstatement of the financial statements in the specific areas assigned to them, and to understand how the results of the audit procedures that they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.
- Provides a basis upon which engagement team members communicate and share new information obtained throughout the audit that may affect the assessment of risks of material misstatement or the audit procedures performed to address these risks.

ISA 240 provides further requirements and guidance in relation to the discussion among the engagement team about the risks of fraud.⁸

A22. As part of the discussion among the engagement team required by paragraph 10, consideration of the disclosure requirements of the applicable financial reporting framework assists in identifying early in the audit where there may be risks of material misstatement in relation to disclosures. Examples of matters the engagement team may discuss include:

- Changes in financial reporting requirements that may result in significant new or revised disclosures;
- Changes in the entity's environment, financial condition or activities that may result in significant new or revised disclosures, for example, a significant business combination in the period under audit;
- Disclosures for which obtaining sufficient appropriate audit evidence may have been difficult in the past; and
- Disclosures about complex matters, including those involving significant management judgment as to what information to disclose.

A23. It is not always necessary or practical for the discussion to include all members in a single discussion (as, for example, in a multi-location audit), nor is it necessary for all of the members of the engagement team to be informed of all of the decisions reached in the discussion. The engagement partner may discuss matters with key members of the engagement team including, if considered appropriate, those with specific skills or knowledge, and those responsible for the audits of components, while delegating discussion with others, taking account of the extent of communication considered necessary throughout the engagement team. A communications plan, agreed by the engagement partner, may be useful.

Considerations Specific to Smaller Entities

A24. Many small audits are carried out entirely by the engagement partner (who may be a sole practitioner). In such situations, it is the engagement partner who, having personally conducted the planning of the audit, would be responsible for considering the susceptibility of the entity's financial statements to material misstatement due to fraud or error.

The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control

The Entity and Its Environment

Industry, Regulatory and Other External Factors (Ref: Para. 11(a))

Industry Factors

A25. Relevant industry factors include industry conditions such as the competitive environment, supplier and customer relationships, and technological developments. Examples of matters the auditor may consider include:

- The market and competition, including demand, capacity, and price competition.

⁸ ISA 240, paragraph 15

- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

A26. The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement. In such cases, it is important that the engagement team include members with sufficient relevant knowledge and experience.⁹

Regulatory Factors

A27. Relevant regulatory factors include the regulatory environment. The regulatory environment encompasses, among other matters, the applicable financial reporting framework and the legal and political environment. Examples of matters the auditor may consider include:

- Accounting principles and industry-specific practices.
- Regulatory framework for a regulated industry, including requirements for disclosures.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

A28. ISA 250 includes some specific requirements related to the legal and regulatory framework applicable to the entity and the industry or sector in which the entity operates.¹⁰

Considerations specific to public sector entities

A29. For the audits of public sector entities, law, regulation or other authority may affect the entity's operations. Such elements are essential to consider when obtaining an understanding of the entity and its environment.

Other External Factors

A30. Examples of other external factors affecting the entity that the auditor may consider include the general economic conditions, interest rates and availability of financing, and inflation or currency revaluation.

Nature of the Entity (Ref: Para. 11(b))

A31. An understanding of the nature of an entity enables the auditor to understand such matters as:

⁹ ISA 220, *Quality Control for an Audit of Financial Statements*, paragraph 14

¹⁰ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, paragraph 12

- Whether the entity has a complex structure, for example, with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately and whether adequate disclosure of such issues in the financial statements has been made.
- The ownership, and relationships between owners and other people or entities. This understanding assists in determining whether related party transactions have been appropriately identified, accounted for, and adequately disclosed in the financial statements. ISA 550¹¹ establishes requirements and provides guidance on the auditor's considerations relevant to related parties.

A32. Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity include:

- Business operations such as:
 - Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
 - Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
 - Alliances, joint ventures, and outsourcing activities.
 - Geographic dispersion and industry segmentation.
 - Location of production facilities, warehouses, and offices, and location and quantities of inventories.
 - Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post-employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters).
 - Research and development activities and expenditures.
 - Transactions with related parties.
- Investments and investment activities such as:
 - Planned or recently executed acquisitions or divestitures.
 - Investments and dispositions of securities and loans.
 - Capital investment activities.
 - Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.
- Financing and financing activities such as:
 - Major subsidiaries and associated entities, including consolidated and non-consolidated structures.

¹¹ ISA 550, *Related Parties*

- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.
- Financial reporting practices such as:
 - Accounting principles and industry-specific practices, including for industry-specific significant classes of transactions, account balances and related disclosures in the financial statements (for example, loans and investments for banks, or research and development for pharmaceuticals).
 - Revenue recognition.
 - Accounting for fair values.
 - Foreign currency assets, liabilities and transactions.
 - Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation).

A33. Significant changes in the entity from prior periods may give rise to, or change, risks of material misstatement.

Nature of Special-Purpose Entities

A34. A special-purpose entity (sometimes referred to as a special-purpose vehicle) is an entity that is generally established for a narrow and well-defined purpose, such as to effect a lease or a securitization of financial assets, or to carry out research and development activities. It may take the form of a corporation, trust, partnership or unincorporated entity. The entity on behalf of which the special-purpose entity has been created may often transfer assets to the latter (for example, as part of a derecognition transaction involving financial assets), obtain the right to use the latter's assets, or perform services for the latter, while other parties may provide the funding to the latter. As ISA 550 indicates, in some circumstances, a special-purpose entity may be a related party of the entity.¹²

A35. Financial reporting frameworks often specify detailed conditions that are deemed to amount to control, or circumstances under which the special-purpose entity should be considered for consolidation. The interpretation of the requirements of such frameworks often demands a detailed knowledge of the relevant agreements involving the special-purpose entity.

The Entity's Selection and Application of Accounting Policies (Ref: Para. 11(c))

A36. An understanding of the entity's selection and application of accounting policies may encompass such matters as:

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

¹² ISA 550, paragraph A7

- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

Objectives and Strategies and Related Business Risks (Ref: Para. 11(d))

- A37. The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.
- A38. Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:
- The development of new products or services that may fail;
 - A market which, even if successfully developed, is inadequate to support a product or service; or
 - Flaws in a product or service that may result in liabilities and reputational risk.
- A39. An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.
- A40. Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements include:
- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
 - New products and services (a potential related business risk might be, for example, that there is increased product liability).
 - Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
 - New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
 - Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
 - Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
 - Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

- A41. A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Examples of conditions and events that may indicate risks of material misstatement are indicated in Appendix 2.
- A42. Usually, management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraph 15 and paragraphs A88–A89.

Considerations Specific to Public Sector Entities

- A43. For the audits of public sector entities, “management objectives” may be influenced by concerns regarding public accountability and may include objectives which have their source in law, regulation or other authority.

Measurement and Review of the Entity's Financial Performance (Ref: Para. 11(e))

- A44. Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. See ISA 240 for requirements and guidance in relation to the risks of fraud.
- A45. The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in paragraphs A110–A121), though their purposes may overlap:
- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
 - Monitoring of controls is specifically concerned with the effective operation of internal control.
- In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control.
- A46. Examples of internally-generated information used by management for measuring and reviewing financial performance, and which the auditor may consider, include:
- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.

- Period-on-period financial performance analyses.
 - Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
 - Employee performance measures and incentive compensation policies.
 - Comparisons of an entity's performance with that of competitors.
- A47. External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.
- A48. Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Considerations Specific to Smaller Entities

- A49. Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

The Entity's Internal Control (Ref: Para. 12)

- A50. An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing and extent of further audit procedures.
- A51. The following application material on internal control is presented in four sections, as follows:
- General Nature and Characteristics of Internal Control.
 - Controls Relevant to the Audit.
 - Nature and Extent of the Understanding of Relevant Controls.
 - Components of Internal Control.

General Nature and Characteristics of Internal Control

Purpose of Internal Control

- A52. Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives that concern:
- The reliability of the entity's financial reporting;
 - The effectiveness and efficiency of its operations; and

- Its compliance with applicable laws and regulations.

The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Considerations specific to smaller entities

- A53. Smaller entities may use less structured means and simpler processes and procedures to achieve their objectives.

Limitations of Internal Control

- A54. Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of their achievement is affected by the inherent limitations of internal control. These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error. For example, there may be an error in the design of, or in the change to, a control. Equally, the operation of a control may not be effective, such as where information produced for the purposes of internal control (for example, an exception report) is not effectively used because the individual responsible for reviewing the information does not understand its purpose or fails to take appropriate action.
- A55. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.
- A56. Further, in designing and implementing controls, management may make judgments on the nature and extent of the controls it chooses to implement, and the nature and extent of the risks it chooses to assume.

Considerations specific to smaller entities

- A57. Smaller entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, in a small owner-managed entity, the owner-manager may be able to exercise more effective oversight than in a larger entity. This oversight may compensate for the generally more limited opportunities for segregation of duties.
- A58. On the other hand, the owner-manager may be more able to override controls because the system of internal control is less structured. This is taken into account by the auditor when identifying the risks of material misstatement due to fraud.

Division of Internal Control into Components

- A59. The division of internal control into the following five components, for purposes of the ISA, provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit:
- (a) The control environment;
 - (b) The entity's risk assessment process;

- (c) The information system, including the related business processes, relevant to financial reporting, and communication;
- (d) Control activities; and
- (e) Monitoring of controls.

The division does not necessarily reflect how an entity designs, implements and maintains internal control, or how it may classify any particular component. Auditors may use different terminology or frameworks to describe the various aspects of internal control, and their effect on the audit than those used in this ISA, provided all the components described in this ISA are addressed.

A60. Application material relating to the five components of internal control as they relate to a financial statement audit is set out in paragraphs A77–A121 below. Appendix 1 provides further explanation of these components of internal control.

Characteristics of Manual and Automated Elements of Internal Control Relevant to the Auditor's Risk Assessment

A61. An entity's system of internal control contains manual elements and often contains automated elements. The characteristics of manual or automated elements are relevant to the auditor's risk assessment and further audit procedures based thereon.

A62. The use of manual or automated elements in internal control also affects the manner in which transactions are initiated, recorded, processed, and reported:

- Controls in a manual system may include such procedures as approvals and reviews of transactions, and reconciliations and follow-up of reconciling items. Alternatively, an entity may use automated procedures to initiate, record, process, and report transactions, in which case records in electronic format replace paper documents.
- Controls in IT systems consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT.

An entity's mix of manual and automated elements in internal control varies with the nature and complexity of the entity's use of IT.

A63. Generally, IT benefits an entity's internal control by enabling an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information;
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures;

- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

A64. IT also poses specific risks to an entity's internal control, including, for example:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorized changes to data in master files.
- Unauthorized changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

A65. Manual elements in internal control may be more suitable where judgment and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

A66. Manual elements in internal control may be less reliable than automated elements because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed. Manual control elements may be less suitable for the following circumstances:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented, or detected and corrected, by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

A67. The extent and nature of the risks to internal control vary depending on the nature and characteristics of the entity's information system. The entity responds to the risks arising from the use of IT or from use of manual elements in internal control by establishing effective controls in light of the characteristics of the entity's information system.

Controls Relevant to the Audit

- A68. There is a direct relationship between an entity's objectives and the controls it implements to provide reasonable assurance about their achievement. The entity's objectives, and therefore controls, relate to financial reporting, operations and compliance; however, not all of these objectives and controls are relevant to the auditor's risk assessment.
- A69. Factors relevant to the auditor's judgment about whether a control, individually or in combination with others, is relevant to the audit may include such matters as the following:
- Materiality.
 - The significance of the related risk.
 - The size of the entity.
 - The nature of the entity's business, including its organization and ownership characteristics.
 - The diversity and complexity of the entity's operations.
 - Applicable legal and regulatory requirements.
 - The circumstances and the applicable component of internal control.
 - The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations.
 - Whether, and how, a specific control, individually or in combination with others, prevents, or detects and corrects, material misstatement.
- A70. Controls over the completeness and accuracy of information produced by the entity may be relevant to the audit if the auditor intends to make use of the information in designing and performing further procedures. Controls relating to operations and compliance objectives may also be relevant to an audit if they relate to data the auditor evaluates or uses in applying audit procedures.
- A71. Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to both financial reporting and operations objectives. The auditor's consideration of such controls is generally limited to those relevant to the reliability of financial reporting.
- A72. An entity generally has controls relating to objectives that are not relevant to an audit and therefore need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as an airline's system of automated controls to maintain flight schedules), but these controls ordinarily would not be relevant to the audit. Further, although internal control applies to the entire entity or to any of its operating units or business processes, an understanding of internal control relating to each of the entity's operating units and business processes may not be relevant to the audit.

Considerations Specific to Public Sector Entities

- A73. Public sector auditors often have additional responsibilities with respect to internal control, for example, to report on compliance with an established code of practice. Public sector auditors can also have responsibilities to report on compliance with law, regulation or other authority. As a result, their review of internal control may be broader and more detailed.

Nature and Extent of the Understanding of Relevant Controls (Ref: Para. 13)

A74. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Implementation of a control means that the control exists and that the entity is using it. There is little point in assessing the implementation of a control that is not effective, and so the design of a control is considered first. An improperly designed control may represent a significant deficiency in internal control.

A75. Risk assessment procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- Inquiring of entity personnel.
- Observing the application of specific controls.
- Inspecting documents and reports.
- Tracing transactions through the information system relevant to financial reporting.

Inquiry alone, however, is not sufficient for such purposes.

A76. Obtaining an understanding of an entity's controls is not sufficient to test their operating effectiveness, unless there is some automation that provides for the consistent operation of the controls. For example, obtaining audit evidence about the implementation of a manual control at a point in time does not provide audit evidence about the operating effectiveness of the control at other times during the period under audit. However, because of the inherent consistency of IT processing (see paragraph A63), performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the auditor's assessment and testing of controls such as those over program changes. Tests of the operating effectiveness of controls are further described in ISA 330.¹³

Components of Internal Control—Control Environment (Ref: Para. 14)

A77. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organization, influencing the control consciousness of its people.

A78. Elements of the control environment that may be relevant when obtaining an understanding of the control environment include the following:

- (a) *Communication and enforcement of integrity and ethical values* – These are essential elements that influence the effectiveness of the design, administration and monitoring of controls.
- (b) *Commitment to competence* – Matters such as management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

¹³ ISA 330, *The Auditor's Responses to Assessed Risks*

- (c) *Participation by those charged with governance* – Attributes of those charged with governance such as:
- Their independence from management.
 - Their experience and stature.
 - The extent of their involvement and the information they receive, and the scrutiny of activities.
 - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
- (d) *Management's philosophy and operating style* – Characteristics such as management's:
- Approach to taking and managing business risks.
 - Attitudes and actions toward financial reporting.
 - Attitudes toward information processing and accounting functions and personnel.
- (e) *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- (f) *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- (g) *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counselling, promotion, compensation, and remedial actions.

Audit Evidence for Elements of the Control Environment

- A79. Relevant audit evidence may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents. For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior. The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code.
- A80. The auditor may also consider how management has responded to the findings and recommendations of the internal audit function regarding identified deficiencies in internal control relevant to the audit, including whether and how such responses have been implemented, and whether they have been subsequently evaluated by the internal audit function.

Effect of the Control Environment on the Assessment of the Risks of Material Misstatement

- A81. Some elements of an entity's control environment have a pervasive effect on assessing the risks of material misstatement. For example, an entity's control consciousness is influenced significantly by those charged with governance, because one of their roles is to counterbalance pressures on management in relation to financial reporting that may arise from market demands or remuneration

schemes. The effectiveness of the design of the control environment in relation to participation by those charged with governance is therefore influenced by such matters as:

- Their independence from management and their ability to evaluate the actions of management.
- Whether they understand the entity's business transactions.
- The extent to which they evaluate whether the financial statements are prepared in accordance with the applicable financial reporting framework, including whether the financial statements include adequate disclosures.

- A82. An active and independent board of directors may influence the philosophy and operating style of senior management. However, other elements may be more limited in their effect. For example, although human resource policies and practices directed toward hiring competent financial, accounting, and IT personnel may reduce the risk of errors in processing financial information, they may not mitigate a strong bias by top management to overstate earnings.
- A83. The existence of a satisfactory control environment can be a positive factor when the auditor assesses the risks of material misstatement. However, although it may help reduce the risk of fraud, a satisfactory control environment is not an absolute deterrent to fraud. Conversely, deficiencies in the control environment may undermine the effectiveness of controls, in particular in relation to fraud. For example, management's failure to commit sufficient resources to address IT security risks may adversely affect internal control by allowing improper changes to be made to computer programs or to data, or unauthorized transactions to be processed. As explained in ISA 330, the control environment also influences the nature, timing and extent of the auditor's further procedures.¹⁴
- A84. The control environment in itself does not prevent, or detect and correct, a material misstatement. It may, however, influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement.

Considerations Specific to Smaller Entities

- A85. The control environment within small entities is likely to differ from larger entities. For example, those charged with governance in small entities may not include an independent or outside member, and the role of governance may be undertaken directly by the owner-manager where there are no other owners. The nature of the control environment may also influence the significance of other controls, or their absence. For example, the active involvement of an owner-manager may mitigate certain of the risks arising from a lack of segregation of duties in a small entity; it may, however, increase other risks, for example, the risk of override of controls.
- A86. In addition, audit evidence for elements of the control environment in smaller entities may not be available in documentary form, in particular where communication between management and other personnel may be informal, yet effective. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasizes the importance of integrity and ethical behavior through oral communication and by management example.
- A87. Consequently, the attitudes, awareness and actions of management or the owner-manager are of particular importance to the auditor's understanding of a smaller entity's control environment.

¹⁴ ISA 330, paragraphs A2–A3

Components of Internal Control—The Entity's Risk Assessment Process (Ref: Para. 15)

A88. The entity's risk assessment process forms the basis for how management determines the risks to be managed. If that process is appropriate to the circumstances, including the nature, size and complexity of the entity, it assists the auditor in identifying risks of material misstatement. Whether the entity's risk assessment process is appropriate to the circumstances is a matter of judgment.

Considerations Specific to Smaller Entities (Ref: Para. 17)

A89. There is unlikely to be an established risk assessment process in a small entity. In such cases, it is likely that management will identify risks through direct personal involvement in the business. Irrespective of the circumstances, however, inquiry about identified risks and how they are addressed by management is still necessary.

*Components of Internal Control—The Information System, Including Related Business Processes, Relevant to Financial Reporting, and Communication**The Information System, Including Related Business Processes, Relevant to Financial Reporting* (Ref: Para. 18)

A90. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures and records designed and established to:

- Initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity;
- Resolve incorrect processing of transactions, for example, automated suspense files and procedures followed to clear suspense items out on a timely basis;
- Process and account for system overrides or bypasses to controls;
- Transfer information from transaction processing systems to the general ledger;
- Capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortization of assets and changes in the recoverability of accounts receivables; and
- Ensure information required to be disclosed by the applicable financial reporting framework is accumulated, recorded, processed, summarized and appropriately reported in the financial statements

A91. Financial statements may contain information that is obtained from outside of the general and subsidiary ledgers. Examples of such information may include:

- Information obtained from lease agreements disclosed in the financial statements, such as renewal options or future lease payments.
- Information disclosed in the financial statements that is produced by an entity's risk management system.
- Fair value information produced by management's experts and disclosed in the financial statements.
- Information disclosed in the financial statements that has been obtained from models, or from other calculations used to develop estimates recognized or disclosed in the financial

statements, including information relating to the underlying data and assumptions used in those models, such as:

- Assumptions developed internally that may affect an asset's useful life; or
- Data such as interest rates that are affected by factors outside the control of the entity.
- Information disclosed in the financial statements about sensitivity analyses derived from financial models that demonstrates that management has considered alternative assumptions.
- Information recognized or disclosed in the financial statements that has been obtained from an entity's tax returns and records.
- Information disclosed in the financial statements that has been obtained from analyses prepared to support management's assessment of the entity's ability to continue as a going concern, such as disclosures, if any, related to events or conditions that have been identified that may cast significant doubt on the entity's ability to continue as a going concern.¹⁵

A92. The understanding of the information system relevant to financial reporting required by paragraph 18 of this ISA (including the understanding of relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers) is a matter of the auditor's professional judgment. For example, certain amounts or disclosures in the entity's financial statements (such as disclosures about credit risk, liquidity risk, and market risk) may be based on information obtained from the entity's risk management system. However, the auditor is not required to understand all aspects of the risk management system, and uses professional judgment in determining the necessary understanding.

Journal entries (Ref: Para. 18(f))

A93. An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions. Examples might be journal entries to record sales, purchases, and cash disbursements in the general ledger, or to record accounting estimates that are periodically made by management, such as changes in the estimate of uncollectible accounts receivable.

A94. An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments. Examples of such entries include consolidating adjustments and entries for a business combination or disposal or non-recurring estimates such as the impairment of an asset. In manual general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. When automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may therefore be more easily identified through the use of computer-assisted audit techniques.

Related business processes (Ref: Para. 18)

A95. An entity's business processes are the activities designed to:

- Develop, purchase, produce, sell and distribute an entity's products and services;

¹⁵ See paragraphs 19–20 of ISA 570 (Revised), *Going Concern*.

- Ensure compliance with laws and regulations; and
- Record information, including accounting and financial reporting information.

Business processes result in the transactions that are recorded, processed and reported by the information system. Obtaining an understanding of the entity's business processes, which include how transactions are originated, assists the auditor obtain an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances.

Considerations specific to smaller entities (Ref: Para. 18)

A96. The information system, and related business processes relevant to financial reporting in small entities, including relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside of the general and subsidiary ledgers, is likely to be less sophisticated than in larger entities, but its role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Understanding the entity's information systems relevant to financial reporting may therefore be easier in an audit of smaller entities, and may be more dependent on inquiry than on review of documentation. The need to obtain an understanding, however, remains important.

Communication (Ref: Para. 19)

A97. Communication by the entity of the financial reporting roles and responsibilities and of significant matters relating to financial reporting involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes such matters as the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Communication may take such forms as policy manuals and financial reporting manuals. Open communication channels help ensure that exceptions are reported and acted on.

Considerations specific to smaller entities

A98. Communication may be less structured and easier to achieve in a small entity than in a larger entity due to fewer levels of responsibility and management's greater visibility and availability.

Components of Internal Control—Control Activities Relevant to the Audit (Ref: Para. 20)

A99. Control activities are the policies and procedures that help ensure that management directives are carried out. Control activities, whether within IT or manual systems, have various objectives and are applied at various organizational and functional levels. Examples of specific control activities include those relating to the following:

- Authorization.
- Performance reviews.
- Information processing.
- Physical controls.
- Segregation of duties.

A100. Control activities that are relevant to the audit are:

- Those that are required to be treated as such, being control activities that relate to significant risks and those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence, as required by paragraphs 29 and 30, respectively; or
- Those that are considered to be relevant in the judgment of the auditor.

A101. The auditor's judgment about whether a control activity is relevant to the audit is influenced by the risk that the auditor has identified that may give rise to a material misstatement and whether the auditor thinks it is likely to be appropriate to test the operating effectiveness of the control in determining the extent of substantive testing.

A102. The auditor's emphasis may be on identifying and obtaining an understanding of control activities that address the areas where the auditor considers that risks of material misstatement are likely to be higher. When multiple control activities each achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to such objective.

A103. Control activities relevant to the audit may include controls established by management that address risks of material misstatement related to disclosures not being prepared in accordance with the applicable financial reporting framework, in addition to controls that address risks related to account balances and transactions. Such control activities may relate to information included in the financial statements that is obtained from outside of the general and subsidiary ledgers.

A104. The auditor's knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control assists the auditor in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities.

Considerations Specific to Smaller Entities

A105. The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate may vary. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over important account balances and transactions, lessening or removing the need for more detailed control activities.

A106. Control activities relevant to the audit of a smaller entity are likely to relate to the main transaction cycles such as revenues, purchases and employment expenses.

Risks Arising from IT (Ref: Para. 21)

A107. The use of IT affects the way that control activities are implemented. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process, and include effective general IT controls and application controls.

A108. General IT controls are policies and procedures that relate to many applications and support the effective functioning of application controls. They apply to mainframe, miniframe, and end-user environments. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data center and network operations.

- System software acquisition, change and maintenance.
- Program change.
- Access security.
- Application system acquisition, development, and maintenance.

They are generally implemented to deal with the risks referred to in paragraph A64 above.

A109. Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventive or detective in nature and are designed to ensure the integrity of the accounting records. Accordingly, application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, and numerical sequence checks with manual follow-up of exception reports or correction at the point of data entry.

Components of Internal Control—Monitoring of Controls (Ref: Para. 22)

A110. Monitoring of controls is a process to assess the effectiveness of internal control performance over time. It involves assessing the effectiveness of controls on a timely basis and taking necessary remedial actions. Management accomplishes monitoring of controls through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory activities.

A111. Management's monitoring activities may include using information from communications from external parties such as customer complaints and regulator comments that may indicate problems or highlight areas in need of improvement.

Considerations Specific to Smaller Entities

A112. Management's monitoring of control is often accomplished by management's or the owner-manager's close involvement in operations. This involvement often will identify significant variances from expectations and inaccuracies in financial data leading to remedial action to the control.

The Entity's Internal Audit Function (Ref: Para. 23)

A113. If the entity has an internal audit function, obtaining an understanding of that function contributes to the auditor's understanding of the entity and its environment, including internal control, in particular the role that the function plays in the entity's monitoring of internal control over financial reporting. This understanding, together with the information obtained from the auditor's inquiries in paragraph 6(a) of this ISA, may also provide information that is directly relevant to the auditor's identification and assessment of the risks of material misstatement.

A114. The objectives and scope of an internal audit function, the nature of its responsibilities and its status within the organization, including the function's authority and accountability, vary widely and depend on the size and structure of the entity and the requirements of management and, where applicable, those charged with governance. These matters may be set out in an internal audit charter or terms of reference.

- A115. The responsibilities of an internal audit function may include performing procedures and evaluating the results to provide assurance to management and those charged with governance regarding the design and effectiveness of risk management, internal control and governance processes. If so, the internal audit function may play an important role in the entity's monitoring of internal control over financial reporting. However, the responsibilities of the internal audit function may be focused on evaluating the economy, efficiency and effectiveness of operations and, if so, the work of the function may not directly relate to the entity's financial reporting.
- A116. The auditor's inquiries of appropriate individuals within the internal audit function in accordance with paragraph 6(a) of this ISA help the auditor obtain an understanding of the nature of the internal audit function's responsibilities. If the auditor determines that the function's responsibilities are related to the entity's financial reporting, the auditor may obtain further understanding of the activities performed, or to be performed, by the internal audit function by reviewing the internal audit function's audit plan for the period, if any, and discussing that plan with the appropriate individuals within the function.
- A117. If the nature of the internal audit function's responsibilities and assurance activities are related to the entity's financial reporting, the auditor may also be able to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed directly by the auditor in obtaining audit evidence. Auditors may be more likely to be able to use the work of an entity's internal audit function when it appears, for example, based on experience in previous audits or the auditor's risk assessment procedures, that the entity has an internal audit function that is adequately and appropriately resourced relative to the size of the entity and the nature of its operations, and has a direct reporting relationship to those charged with governance.
- A118. If, based on the auditor's preliminary understanding of the internal audit function, the auditor expects to use the work of the internal audit function to modify the nature or timing, or reduce the extent, of audit procedures to be performed, ISA 610 (Revised 2013) applies.
- A119. As is further discussed in ISA 610 (Revised 2013), the activities of an internal audit function are distinct from other monitoring controls that may be relevant to financial reporting, such as reviews of management accounting information that are designed to contribute to how the entity prevents or detects misstatements.
- A120. Establishing communications with the appropriate individuals within an entity's internal audit function early in the engagement, and maintaining such communications throughout the engagement, can facilitate effective sharing of information. It creates an environment in which the auditor can be informed of significant matters that may come to the attention of the internal audit function when such matters may affect the work of the auditor. ISA 200 discusses the importance of the auditor planning and performing the audit with professional skepticism, including being alert to information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence. Accordingly, communication with the internal audit function throughout the engagement may provide opportunities for internal auditors to bring such information to the auditor's attention. The auditor is then able to take such information into account in the auditor's identification and assessment of risks of material misstatement.

Sources of Information (Ref: Para. 24)

A121. Much of the information used in monitoring may be produced by the entity's information system. If management assumes that data used for monitoring are accurate without having a basis for that assumption, errors that may exist in the information could potentially lead management to incorrect conclusions from its monitoring activities. Accordingly, an understanding of:

- The sources of the information related to the entity's monitoring activities; and
- The basis upon which management considers the information to be sufficiently reliable for the purpose, is required as part of the auditor's understanding of the entity's monitoring activities as a component of internal control.

Identifying and Assessing the Risks of Material Misstatement

Assessment of Risks of Material Misstatement at the Financial Statement Level (Ref: Para. 25(a))

A122. Risks of material misstatement at the financial statement level refer to risks that relate pervasively to the financial statements as a whole and potentially affect many assertions. Risks of this nature are not necessarily risks identifiable with specific assertions at the class of transactions, account balance, or disclosure level. Rather, they represent circumstances that may increase the risks of material misstatement at the assertion level, for example, through management override of internal control. Financial statement level risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud.

A123. Risks at the financial statement level may derive in particular from a deficient control environment (although these risks may also relate to other factors, such as declining economic conditions). For example, deficiencies such as a lack of management competence or lack of oversight over the preparation of the financial statements may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

A124. The auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. For example:

- Concerns about the integrity of the entity's management may be so serious as to cause the auditor to conclude that the risk of management misrepresentation in the financial statements is such that an audit cannot be conducted.
- Concerns about the condition and reliability of an entity's records may cause the auditor to conclude that it is unlikely that sufficient appropriate audit evidence will be available to support an unmodified opinion on the financial statements.

A125. ISA 705 (Revised)¹⁶ establishes requirements and provides guidance in determining whether there is a need for the auditor to express a qualified opinion or disclaim an opinion or, as may be required in some cases, to withdraw from the engagement where withdrawal is possible under applicable law or regulation.

¹⁶ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

Assessment of Risks of Material Misstatement at the Assertion Level (Ref: Para. 25(b))

A126. Risks of material misstatement at the assertion level for classes of transactions, account balances, and disclosures need to be considered because such consideration directly assists in determining the nature, timing and extent of further audit procedures at the assertion level necessary to obtain sufficient appropriate audit evidence. In identifying and assessing risks of material misstatement at the assertion level, the auditor may conclude that the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.

The Use of Assertions

A127. In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement, and presentation of classes of transactions and events, account balances and disclosures.

A128. The auditor may use the assertions as described in paragraph A129(a)–(b) below or may express them differently provided all aspects described below have been covered. For example, the auditor may choose to combine the assertions about classes of transactions and events, and related disclosures, with the assertions about account balances, and related disclosures.

Assertions about classes of transactions, account balances, and related disclosures

A129. Assertions used by the auditor in considering the different types of potential misstatements that may occur may fall into the following categories:

- (a) Assertions about classes of transactions and events, and related disclosures, for the period under audit:
 - (i) Occurrence—transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - (ii) Completeness—all transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
 - (iii) Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - (iv) Cutoff—transactions and events have been recorded in the correct accounting period.
 - (v) Classification—transactions and events have been recorded in the proper accounts.
 - (vi) Presentation—transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
- (b) Assertions about account balances, and related disclosures, at the period end:
 - (i) Existence—assets, liabilities, and equity interests exist.
 - (ii) Rights and obligations—the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

- (iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- (iv) Accuracy, valuation and allocation—assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
- (v) Classification—assets, liabilities and equity interests have been recorded in the proper accounts.
- (vi) Presentation—assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about other disclosures

A130. The assertions described in paragraph 129(a)–(b) above, adapted as appropriate, may also be used by the auditor in considering the different types of potential misstatements that may occur in disclosures not directly related to recorded classes of transactions, events, or account balances. As an example of such a disclosure, the entity may be required to describe its exposure to risks arising from financial instruments, including how the risks arise; the objectives, policies and processes for managing the risks; and the methods used to measure the risks.

Considerations specific to public sector entities

A131. When making assertions about the financial statements of public sector entities, in addition to those assertions set out in paragraph A129(a)–(b), management may often assert that transactions and events have been carried out in accordance with law, regulation or other authority. Such assertions may fall within the scope of the financial statement audit.

Process of Identifying Risks of Material Misstatement (Ref: Para. 26(a))

A132. Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing and extent of further audit procedures to be performed. In identifying the risks of material misstatement in the financial statements, the auditor exercises professional skepticism in accordance with ISA 200.¹⁷

A133. Appendix 2 provides examples of conditions and events that may indicate the existence of risks of material misstatement, including risks of material misstatement relating to disclosures.

A134. As explained in ISA 320,¹⁸ materiality and audit risk are considered when identifying and assessing the risks of material misstatement in classes of transactions, account balances and disclosures. The

¹⁷ ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15

¹⁸ ISA 320, paragraph A1

auditor's determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial reporting needs of users of the financial statements.¹⁹

A135. The auditor's consideration of disclosures in the financial statements when identifying risks includes quantitative and qualitative disclosures, the misstatement of which could be material (i.e., in general, misstatements are considered to be material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements as a whole). Depending on the circumstances of the entity and the engagement, examples of disclosures that will have qualitative aspects and that may be relevant when assessing the risks of material misstatement include disclosures about:

- Liquidity and debt covenants of an entity in financial distress.
- Events or circumstances that have led to the recognition of an impairment loss.
- Key sources of estimation uncertainty, including assumptions about the future.
- The nature of a change in accounting policy, and other relevant disclosures required by the applicable financial reporting framework, where, for example, new financial reporting requirements are expected to have a significant impact on the financial position and financial performance of the entity.
- Share-based payment arrangements, including information about how any amounts recognized were determined, and other relevant disclosures.
- Related parties, and related party transactions.
- Sensitivity analysis, including the effects of changes in assumptions used in the entity's valuation techniques intended to enable users to understand the underlying measurement uncertainty of a recorded or disclosed amount.

Considerations specific to smaller entities

A136. Disclosures in the financial statements of smaller entities may be less detailed or less complex (e.g., some financial reporting frameworks allow smaller entities to provide fewer disclosures in the financial statements). However, this does not relieve the auditor of the responsibility to obtain an understanding of the entity and its environment, including internal control, as it relates to disclosures.

Relating Controls to Assertions (Ref: Para. 26(c))

A137. In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

A138. Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical

¹⁹ ISA 320, paragraph 4

inventory relate directly to the existence and completeness assertions for the inventory account balance.

A139. Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Material Misstatements

A140. Potential misstatements in individual statements and disclosures may be judged to be material due to size, nature or circumstances. (Ref: Para. 26(d))

Significant Risks

Identifying Significant Risks (Ref: Para. 28)

A141. Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.

A142. Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

A143. Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

A144. ISA 330 describes the consequences for further audit procedures of identifying a risk as significant.²⁰

²⁰ ISA 330, paragraphs 15 and 21

Significant risks relating to the risks of material misstatement due to fraud

A145. ISA 240 provides further requirements and guidance in relation to the identification and assessment of the risks of material misstatement due to fraud.²¹

Understanding Controls Related to Significant Risks (Ref: Para. 29)

A146. Although risks relating to significant non-routine or judgmental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Accordingly, the auditor's understanding of whether the entity has designed and implemented controls for significant risks arising from non-routine or judgmental matters includes whether and how management responds to the risks. Such responses might include:

- Control activities such as a review of assumptions by senior management or experts.
- Documented processes for estimations.
- Approval by those charged with governance.

A147. For example, where there are one-off events such as the receipt of notice of a significant lawsuit, consideration of the entity's response may include such matters as whether it has been referred to appropriate experts (such as internal or external legal counsel), whether an assessment has been made of the potential effect, and how it is proposed that the circumstances are to be disclosed in the financial statements.

A148. In some cases, management may not have appropriately responded to significant risks of material misstatement by implementing controls over these significant risks. Failure by management to implement such controls is an indicator of a significant deficiency in internal control.²²

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence (Ref: Para. 30)

A149. Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

A150. Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

²¹ ISA 240, paragraphs 25–27

²² ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, paragraph A7

A151. The consequences for further audit procedures of identifying such risks are described in ISA 330.²³

Revision of Risk Assessment (Ref: Para. 31)

A152. During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements. See ISA 330 for further guidance.

Documentation (Ref: Para. 32)

A153. The manner in which the requirements of paragraph 32 are documented is for the auditor to determine using professional judgment. For example, in audits of small entities the documentation may be incorporated in the auditor's documentation of the overall strategy and audit plan.²⁴ Similarly, for example, the results of the risk assessment may be documented separately, or may be documented as part of the auditor's documentation of further procedures.²⁵ The form and extent of the documentation is influenced by the nature, size and complexity of the entity and its internal control, availability of information from the entity and the audit methodology and technology used in the course of the audit.

A154. For entities that have uncomplicated businesses and processes relevant to financial reporting, the documentation may be simple in form and relatively brief. It is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of understanding documented by the auditor include those on which the auditor based the assessment of the risks of material misstatement.

A155. The extent of documentation may also reflect the experience and capabilities of the members of the audit engagement team. Provided the requirements of ISA 230 are always met, an audit undertaken by an engagement team comprising less experienced individuals may require more detailed documentation to assist them to obtain an appropriate understanding of the entity than one that includes experienced individuals.

A156. For recurring audits, certain documentation may be carried forward, updated as necessary to reflect changes in the entity's business or processes.

²³ ISA 330, paragraph 8

²⁴ ISA 300, *Planning an Audit of Financial Statements*, paragraphs 7 and 9

²⁵ ISA 330, paragraph 28

Appendix 1

(Ref: Para. 4(c), 14–24, A77–A121)

Internal Control Components

1. This appendix further explains the components of internal control, as set out in paragraphs 4(c), 14–24 and A77–A121, as they relate to a financial statement audit.

Control Environment

2. The control environment encompasses the following elements:
 - (a) *Communication and enforcement of integrity and ethical values.* The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical behavior are the product of the entity's ethical and behavioral standards, how they are communicated, and how they are reinforced in practice. The enforcement of integrity and ethical values includes, for example, management actions to eliminate or mitigate incentives or temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. The communication of entity policies on integrity and ethical values may include the communication of behavioral standards to personnel through policy statements and codes of conduct and by example.
 - (b) *Commitment to competence.* Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job.
 - (c) *Participation by those charged with governance.* An entity's control consciousness is influenced significantly by those charged with governance. The importance of the responsibilities of those charged with governance is recognized in codes of practice and other laws and regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control.
 - (d) *Management's philosophy and operating style.* Management's philosophy and operating style encompass a broad range of characteristics. For example, management's attitudes and actions toward financial reporting may manifest themselves through conservative or aggressive selection from available alternative accounting principles, or conscientiousness and conservatism with which accounting estimates are developed.
 - (e) *Organizational structure.* Establishing a relevant organizational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. The appropriateness of an entity's organizational structure depends, in part, on its size and the nature of its activities.
 - (f) *Assignment of authority and responsibility.* The assignment of authority and responsibility may include policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it may include policies and communications directed at ensuring that all personnel understand the entity's objectives,

know how their individual actions interrelate and contribute to those objectives, and recognize how and for what they will be held accountable.

- (g) *Human resource policies and practices.* Human resource policies and practices often demonstrate important matters in relation to the control consciousness of an entity. For example, standards for recruiting the most qualified individuals – with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior – demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behavior. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Entity's Risk Assessment Process

3. For financial reporting purposes, the entity's risk assessment process includes how management identifies business risks relevant to the preparation of financial statements in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to respond to and manage them and the results thereof. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements.
4. Risks relevant to reliable financial reporting include external and internal events, transactions or circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:
 - *Changes in operating environment.* Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
 - *New personnel.* New personnel may have a different focus on or understanding of internal control.
 - *New or revamped information systems.* Significant and rapid changes in information systems can change the risk relating to internal control.
 - *Rapid growth.* Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
 - *New technology.* Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
 - *New business models, products, or activities.* Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
 - *Corporate restructurings.* Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.

- *Expanded foreign operations.* The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- *New accounting pronouncements.* Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

5. An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Many information systems make extensive use of information technology (IT).
6. The information system relevant to financial reporting objectives, which includes the financial reporting system, encompasses methods and records that:
 - Identify and record all valid transactions.
 - Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
 - Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
 - Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
 - Present properly the transactions and related disclosures in the financial statements.
7. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports.
8. Communication, which involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting, may take such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Control Activities

9. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures that pertain to the following:
 - *Performance reviews.* These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data – operating or financial – to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance.
 - *Information processing.* The two broad groupings of information systems control activities are application controls, which apply to the processing of individual applications, and general IT controls, which are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation

of information systems. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. Examples of general IT controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- *Physical controls.* Controls that encompass:
 - The physical security of assets, including adequate safeguards such as secured facilities over access to assets and records.
 - The authorization for access to computer programs and data files.
 - The periodic counting and comparison with amounts shown on control records (for example, comparing the results of cash, security and inventory counts with accounting records).

The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation.

- *Segregation of duties.* Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets. Segregation of duties is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of the person's duties.
10. Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorization controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Monitoring of Controls

11. An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal auditors' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies. Monitoring is done also to ensure that controls continue to operate effectively over time. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them.
12. Internal auditors or personnel performing similar functions may contribute to the monitoring of an entity's controls through separate evaluations. Ordinarily, they regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the effectiveness of

internal control, and communicate information about strengths and deficiencies in internal control and recommendations for improving internal control.

13. Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external auditors in performing monitoring activities.

Appendix 2

(Ref: Para. A41, A133)

Conditions and Events That May Indicate Risks of Material Misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement in the financial statements. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off balance sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Deficiencies in internal control, especially those not addressed by management.
- Incentives for management and employees to engage in fraudulent financial reporting.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.

- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates, and related disclosures.
- Omission, or obscuring, of significant information in disclosures.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.



Meeting: IAASB
Meeting Location: Lima, Peru
Meeting Dates: March 13–17, 2017

Agenda Item 4

ISA 315 (Revised)¹

Objective of Agenda Item

1. The objective of this agenda item is to obtain the Board's views on the ISA 315 (Revised) Task Force's (the Task Force) views and recommendations related to various matters described in **Agenda Item 4-A**.

ISA 315 (Revised) Task Force

2. The Task Force comprises the following members:
 - Fiona Campbell, IAASB Member and Task Force Chair (supported by Denise Weber, IAASB Technical Advisor)
 - Marek Grabowski, IAASB Member (supported by Josephine Jackson, IAASB Technical Advisor)
 - Chuck Landes, IAASB Member (supported by Hiram Hasty, IAASB Technical Advisor)
 - Susan Jones, IAASB Technical Advisor
 - Katharine Bagshaw, International Federation of Accountants Small- and Medium-Sized Practices (SMP) Committee Member
 - Megan Zietsman, IAASB Deputy Chair (correspondent member)

Activities of the Task Force

3. The Task Force has had one physical meeting and two teleconferences to develop **Agenda Item 4–A** since the December 2016 IAASB meeting.
4. Other outreach activities and coordination since the December 2016 IAASB meeting include:
 - Some Task Force members, including the Task Force Chair, participated in a teleconference with the United States Public Company Accounting Oversight Board (PCAOB) staff in January 2017 that included discussions related to the PCAOB's risk assessment standards;
 - Task Force Chair and IAASB staff teleconference in January 2017 with some members of the Data Analytics Working Group (DAWG), including the DAWG Chair, to debrief on the Task Force's views on the DAWG's recommendations for possible changes to ISA 315 (Revised) for data analytics; and
 - Task Force Chair and IAASB Staff videoconference in December 2016 with representatives from the Nordic Federation of Public Accountants with respect to feedback received to its consultation on the [Nordic Standard for Audits of Small Entities](#) relating to ISA 315 (Revised).

¹ International Standard on Auditing (ISA) 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

5. In January 2017, the IAASB co-hosted a conference for SMPs and auditors of small- and medium-sized entities to discuss matters relating to the ISAs, as well as the IAASB's other International Standards. Although not specifically on the agenda, matters relating to challenges in applying ISA 315 (Revised) were discussed.

Action Requested

6. The IAASB is asked to share its views on the Task Force's views and recommendations presented in **Agenda Item 4–A**.

Material Presented

Agenda Item 4–A	ISA 315 (Revised)—Issues and Task Force Recommendations
Supplement	ISA 315 (Revised)—ISA 315 (Revised) per the 2016–2017 IAASB Handbook

Meeting: IAASB
Meeting Location: Lima, Peru
Meeting Date: March 13–17, 2017

Agenda Item 5

Professional Skepticism

Objectives of Agenda Item

1. To receive an oral update on the activities of the joint Professional Skepticism Working Group (PSWG) and the IAASB Professional Skepticism Subgroup (the Subgroup)¹ since the December 2016 meeting from the Working Group Chair.

Professional Skepticism Working Group

2. The PSWG includes representatives from the IAASB, the International Ethics Standards Board for Accountants (IESBA), and the International Accounting Education Standards Board (IAESB) and is comprised of the following members:
 - Prof. Annette Köhler, WG Chair, IAASB Member (support to WG Chair: Wolfgang Böhm, IAASB Technical Advisor).
 - Charles E. Landes, IAASB Vice Chair.
 - Susan Jones, IAASB Technical Advisor.
 - Richard Fleck, IESBA Deputy Chair.
 - Patricia Mulvaney, IESBA Member.
 - Dave Simko, IAESB Member.
 - Bernard Agulhas, IAESB Member.

Activities since the Last IAASB Discussion

3. Subsequent to the December 2016 IAASB meeting, the joint PSWG held a teleconference to share updates of the IAASB, IESBA, and IAESB, as well as the proposed next steps.
4. The Subgroup held a teleconference to further discuss matters related to potential changes to the concept/definition of professional skepticism within the ISAs.
5. Minutes of the December 2016 discussion of the IAASB on Professional Skepticism can be found in the Appendix.

¹ Following the March 2016 IAASB Board meeting, a subgroup of the PSWG was formed (PSWG-IAASB Subgroup or the Subgroup) in order to address specific areas for consideration raised by the Board. The Subgroup consists of the IAASB-related members of the PSWG.

Minutes – IAASB September 2016 Meeting²

Prof Köhler presented **Agenda Item 5-A** to the Board and provided an update of the activities of the Professional Skepticism Working Group (PSWG) since the September 2016 Board meeting. Prof Kohler highlighted the work streams being pursued by the different Boards, and explained that it is not clear what the IAESB is interested in with the planned literature review, but that she would report back to the Board with this information.

JOINT PSWG ACTIVITIES

Prof. Kohler highlighted that the PSWG will develop a joint Professional Skepticism stakeholder communication that would give prominence to the work, individually and in coordination that the standard-setting boards (SSBs) will be undertaking in response to the feedback received by all three SSBs. The IAASB asked the PSWG to clarify:

- The purpose of the stakeholder communication and whether it would seek to obtain additional feedback in some way or serve as an “awareness” piece.
- What is meant by “call to action” and to whom it relates.

EXPLORING FUNDAMENTAL CHANGES TO THE CONCEPT OF PROFESSIONAL SKEPTICISM

The following views were expressed about the PSWG’s discussion of the potential changes to the concept of professional skepticism within the ISAs:

- Concern with the practicality of “No definition of professional skepticism” as an option being analyzed by the PSWG.
- A shift to presumptive doubt would be challenging, while one Board member commented that in his particular jurisdiction, an auditor is not permitted to accept an engagement if he or she has doubts about management.
- Related to the potential option of extending professional skepticism to all professional accountants (PAs), there was the view that the mindset of an auditor is different from that of a professional accountant and that the auditor’s questioning mindset has a clear object, management. But in the case of a professional accountant, who would be the object of their questioning/critical mindset?

The IAASB representatives of the PSWG will focus the analysis of implications and unintended consequences of the following options: 1) A requirement to seek out contradictory evidence, 2) a shift to a more challenging mindset or presumptive doubt, and 3) introducing a concept of levels of professional skepticism.

² These draft minutes are still subject to IAASB review and may be subject to further change.

IESBA SHORT-TERM PROPOSED LANGUAGE

Mr. Richard Fleck (IESBA Deputy Chair and PSWG member) provided the Board with an update regarding the short-term proposals to be considered by the IESBA at its meeting the following week from December 12th–16th. The Board provided the following feedback to the IESBA representatives:

- Support for the proposal to clarify the linkage between professional skepticism and the fundamental principles/independence through additional application material in the IESBA Code of Ethics.
- In relation to the proposed text related to “critical mindset”:
 - It was not clear what problem the proposals regarding a “critical mindset” are attempting to fix.
 - It was noted that the use of the word “mindset” makes a very close link to the “questioning mind” wording in the definition of professional skepticism within the ISAs and instead suggested alternative terms such as “critical thinking.”
 - Given that the term “critical mindset” is a new concept, it is difficult to foresee how it will change auditor behavior, especially for professional accountants in business. It was also noted that there was a risk of unintended consequences.

Prof. Schilder thanked Mr. Fleck for taking steps to be responsive to the feedback provided to him by the IAASB at its September meeting. He summarized the feedback from the board in two ways:

- Generally, the Board members felt the concept was interesting, but struggled to understand what is meant, and expected, by the concept of “critical mindset”; and
- Board members questioned how this concept is different from professional skepticism and how the two terms would be reconciled.

Prof. Schilder closed the session by requesting that Mr. Fleck ask the IESBA to consider sharing a fatal-flaw review of the exposure draft with the full PSWG following the IESBA meeting, prior to its finalization. Mr. Fleck agreed to ask the IESBA to consider this.

WAY FORWARD

For the March 2017 Board meeting, the PSWG intends to present the Board with a draft outline of the stakeholder communication publication.

Agenda Item 6-A

Eligibility of the Engagement Quality Control Reviewer — Issues and Task Force Recommendations

Objective of the IAASB Discussion

The objective of this Agenda item is to obtain the IAASB's feedback on the Quality Control Task Force (QCTF's) recommendations in relation to the eligibility of the engagement quality control (EQC) reviewer, in response to the IAASB's feedback at the September 2016 meeting.

Introduction

1. At the September 2016 IAASB meeting, the QCTF presented their initial proposals on matters related to EQC reviews, including the eligibility of the EQC reviewer, in response to the feedback from respondents to the Invitation to Comment, *Enhancing Audit Quality in the Public Interest: A Focus on Professional Skepticism, Quality Control and Group Audits* (ITC). At the December 2016 IAASB meeting, the QCTF presented their recommendations on the proposed revisions to ISQC 1¹, on the following matters related to EQC reviews:

- (a) Setting the objective of an EQC review;
- (b) Revising the definition of an EQC review;
- (c) Determining the scope of the engagements subject to an EQC review; and
- (d) The execution of an EQC review.

An extract of the IAASB's September 2016 discussions is available in Appendix 2 to this paper.

2. This paper incorporates the QCTF's proposed revisions to ISQC 1 in relation to the eligibility of the EQC reviewer, which includes the QCTF's recommendations to address the time that an individual who had previously been involved in the audit would not be eligible to fill the role of the EQC reviewer (the cooling-off period). Table 1 includes the proposed requirements and application material in relation to the QCTF's recommendations.
3. In developing these proposals, the QCTF considered the purpose and application of the EQC review in light of the revised quality management approach being adopted in ISQC 1. The QCTF recognized that an EQC review is only one of many possible responses that the firm may identify to address quality risks, for example, the firm may perform other types of reviews that are more focused on specific types of risks or the firm may identify other controls to address quality risks. The QCTF notes that the intention of the EQC review is that it is undertaken to address quality risks in relation to engagements that would have a significant impact in the event of a failure, for example, listed entities, engagements that have characteristics similar to listed entities or other engagements identified by the firm that have certain risk characteristics. Accordingly, the QCTF's recommendations in relation to the eligibility of the EQC reviewer were formed in this context.

¹ International Standard on Quality Control (ISQC) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*

Task Force Recommendations

Criteria for Selection of an EQC Reviewer

4. At its September 2016 meeting, the IAASB supported the recommendations of the QCWG relating to the criteria for the selection of the EQC reviewer, although the IAASB cautioned that these should not be overly prescriptive resulting in firms having limited suitable resources who are able, or willing, to fulfill the role. The IAASB also provided the following suggestions:
 - (a) Emphasize that the EQC reviewer needs to have the appropriate authority and status to enable them to confidently challenge the significant judgments.
 - (b) Address the appropriateness of the EQC reviewer's practical experience, for example, circumstances when the EQC review is delegated to a technical resource with limited practical experience.
 - (c) Address the capacity of the EQC reviewer to perform the review, i.e., their time available.
 - (d) Address the appropriate skills of the EQC reviewer.
5. In considering the attributes necessary for the EQC reviewer to be suitably qualified to fulfill the role, the QCTF researched other standards or regulations that address the attributes of the EQC reviewer, as well as the attributes that apply to engagement partners and professional accountants which could apply to the EQC reviewer, including the following:
 - (a) International Education Standard 8 (IES 8)² establishes the professional competence professional accountants develop and maintain when performing the role of an engagement partner. The three main competence areas set up in IES 8 are: (1) technical competence, (2) professional skills and (3) professional values, ethics and attitudes.
 - (b) The Code of Ethics for Professional Accountants issued by the International Ethics Standards Board for Accountants (IESBA Code) sets up the fundamental principles the professional accountant shall apply. Those principles are: (1) integrity, (2) objectivity, (3) professional competence and due care, (4) confidentiality and (5) professional behavior.
 - (c) Article 8 of the Regulation No 537/2014 of the European Parliament and of the Council (the EU Regulation) contains criteria for the EQC reviewer including that the reviewer shall be (1) a statutory auditor who is (2) not involved in the performance of the statutory audit to which the review relates. Several criteria exist for statutory auditors (such as educational qualifications and professional competence) in the EU legislation (amended Directive 2006/43/EC of the European Parliament and of the Council).
 - (d) The PCAOB Auditing Standard No. (AS) 7 requires that the EQC reviewer must be a partner or another individual in an equivalent position. AS 7 includes criteria such as independence, integrity and objectivity, but also addresses the competency of the EQC reviewer, being that they have the level of knowledge and competence related to accounting, auditing and financial reporting that is required to serve as the engagement partner on the engagement under review.

² International Education Standard 8 (IES 8) on Professional Competence for Engagement Partners Responsible for Audits of Financial Statements (Revised)

AS 7 also states that the person who served as the engagement partner during either of the two audits preceding the audit subject to engagement quality review may not be the engagement quality reviewer.

6. The QCTF debated these attributes, taking into consideration the feedback from respondents to the ITC and the views of the IAASB at its September 2016 meeting, and identified the following attributes as necessary in order for an individual to be eligible to perform the EQC review:
- (a) *Appropriate authority*—Paragraph 39 of ISQC 1 indicates that the EQC reviewer needs to have the necessary authority. The QCTF recognizes the concerns of respondents and the IAASB that having the appropriate authority is absolutely essential to the effectiveness of the EQC review. However, the QCTF is of the view that the term “appropriate authority” could be taken to mean that the EQC reviewer must have a particular title or position within the firm, for example, being at the same or higher level within the firm’s hierarchy. The QCTF noted that the purpose of appropriate authority is to establish the ability of the EQC reviewer to confidently challenge the significant judgments made by the engagement team, which would be achieved through the firm establishing the right culture that supports the EQC reviewer in undertaking their role. This in turn would lead to a situation where the engagement team, including the engagement partner, has professional respect for the EQC reviewer and considers the EQC reviewer as a person who can raise appropriate challenges. There are various ways that a firm can establish such a culture and support for the EQC reviewer, for example, the firm may identify a senior individual within the firm who oversees the EQC review process, or the firm’s processes for addressing differences of opinion may be helpful. As proposed to the IAASB in December 2016, one of the components of quality management would be “*organization, culture and strategy that foster quality*.” The QCTF notes that this would also be important to establishing a “culture” that supports the EQC reviewer. (See paragraph A46a–A46b of Table 1)
 - (b) *Technical competence*—Paragraph 39 of ISQC 1 includes technical qualifications as a necessary attribute to be eligible to perform the EQC review, however, the term “qualifications” is not defined in ISQC 1. “Technical competence” is defined in the IAESB *Glossary of Terms* as “the ability to apply professional knowledge³ to perform a role to a defined standard”. The QCTF is of the view that the term “qualifications” appears limited to the education of the EQC reviewer, rather than all-encompassing of the person’s knowledge and ability to apply such knowledge. Furthermore, throughout the ISAs, “competence” is used in relation to the knowledge, experience and skills of the engagement team. Accordingly, the QCTF is of the view that the phrase “technical qualifications” should be replaced with “technical competence”. The QCTF debated whether it would be appropriate to prescribe that the EQC reviewer needs to have the technical competence which is required to serve as the engagement partner on the audit, similar to the approach in AS 7 (see paragraph 5(d)). However the QCTF concluded that the necessary level of competence varies depending on the circumstances of the engagement and that such a requirement may be too restrictive as there could be circumstances where this would not be practicable. Instead, the application material would provide examples of what is

³ “Professional knowledge” is defined in the IAESB *Glossary of Terms* as “Those topics that make up the subject of accountancy as well as other business disciplines that, together, constitute the essential body of knowledge for professional accountants.”

meant by “technical competence”, for example, similar to the examples in paragraph A11 of ISA 220. (See paragraphs 39(a), A47 and A47c–A47d of Table 1)

- (c) *Capacity*—As proposed to the IAASB in December 2016, more emphasis has been brought to the timeliness of the EQC review in addressing the objective of the EQC review, and the nature, timing and extent of the EQC review procedures. In order to echo the importance of performing the EQC review procedures at appropriate stages during the engagement, the QCTF is of the view that the capacity of the individual to perform the EQC review needs to be addressed. Paragraph 30 of ISQC 1 sets the requirement for engagement partners to have the appropriate capabilities to perform their role, while paragraph A30 explains that firms should monitor the workload and availability of engagement partners so as to enable them to have sufficient time to discharge their role. The QCTF is of the view that similar guidance is helpful in relation to the capacity of the EQC reviewer. (See paragraphs 39(a) and A47a of Table 1)
- (d) *Practical experience*—Paragraph 39 of ISQC 1 also mentions having the necessary experience to perform the role of the EQC reviewer. In light of the views of the IAASB regarding the importance of having an appropriate level of experience in performing the role, the QCTF recommends that it be separated from technical competence. In addition, the QCTF is of the view that for audits of financial statements of listed entities, the requirement needs to specify that such experience should include experience related to an audit of financial statements of a listed entity (i.e., the individual was previously involved in an audit of a listed entity, e.g., as an engagement partner, an assistant partner or senior engagement team member). This is necessary in clarifying the minimum expectation for such engagements and ensuring that the EQC reviewer is suitable. Furthermore, in order to respond to the views of respondents, the application material would explain the importance of the firm considering inspection results or other performance ratings related to engagement quality of the proposed EQC reviewer. (See paragraphs 39(b) and A47b–A47d of Table 1)
- (e) *Objectivity*—Paragraph 20 of ISQC 1 requires the firm to establish policies and procedures addressing compliance with relevant ethical requirements by the firm and its personnel (including the EQC reviewer). This is supported by application material which references the fundamental principles of the IESBA Code, which includes the principle of objectivity. **Appendix 1** of this Agenda Item provides an explanation of how the principles in the IESBA Code relate to the objectivity of the EQC reviewer, with a focus on self-review threats, self-interest threats and familiarity threats that may arise in the context of the EQC reviewer’s role when performing the EQC review. Other relevant ethical requirements may also apply to the EQC reviewer, for example, ethical requirements established in the firm’s jurisdiction. Paragraphs 7–15 below further discuss the objectivity of the EQC reviewer, including the time that an individual who had previously served as engagement partner would not be eligible to fulfill the role of the EQC reviewer (cooling-off period). (See paragraphs 39(c) and A47e–A47k of Table 1)

Matter for IAASB Consideration

1. The IAASB is asked to share their views regarding the proposals in relation to the eligibility of the EQC reviewer, in particular:
 - (a) Does the IAASB agree with how the authority of the EQC reviewer would be emphasized in ISQC 1? (See paragraphs A46a–A46b of Table 1)
 - (f) Does the IAASB agree with the proposal that technical competence is a required attribute of the EQC reviewer, and that the characteristics of technical competence would be explained in application material? (See paragraphs 39(a), A47 and A47c–A47d of Table 1)
 - (b) Does the IAASB agree with the proposal that the capacity of the individual to perform the EQC review needs to be addressed in ISQC1? (See paragraphs 39(a) and A47a of Table 1)
 - (c) Does the IAASB agree with the proposal for the inclusion of a specific requirement on relevant experience and if so, to what extent should the requirements be specific in relation to the nature and extent of that experience? (See paragraphs 39(b) and A47b–A47d of Table 1)

Objectivity

7. In considering the objectivity of the EQC reviewer, the QCTF considered how objectivity and threats to objectivity are defined and addressed in the IESBA Code. In doing so, the IAASB Staff, IESBA Staff, Chair of the QCTF and certain members of the IESBA Board discussed the application of the IESBA Code, particularly in light of IESBA's various projects that have been recently completed, or are underway. A detailed explanation of this is provided in **Appendix 1**. IESBA is particularly interested in the discussions of the IAASB in this regard, and intend to discuss the issues related to the objectivity of the EQC reviewer at their meeting in June 2017.
8. Paragraph 20 of ISQC 1 requires the firm to establish policies and procedures in relation to compliance by the firm and its personnel with relevant ethical requirements, and paragraph 25 requires the firm to establish policies and procedures addressing familiarity threats arising from long association of personnel that take into consideration relevant ethical requirements. Nevertheless, the QCTF is of the view that in order to enhance the firm's consideration of the objectivity of the EQC reviewer, that ISQC 1 needs to direct the firm to consider the requirements of law, regulation or relevant ethical requirements. In considering law, regulation or relevant ethical requirements, the firm may identify specific provisions that need to be applied in relation to long association with the client or a cooling-off period for an engagement partner that prohibits them from fulfilling the role of EQC reviewer for a certain period. (See paragraphs 39(c) and A47e of Table 1)
9. Although relevant ethical requirements address the principle of objectivity and the threats that may arise through the application of the fundamental principles, the QCTF is of the view that there are certain threats to objectivity that are unique to the EQC reviewer in the context of their role (i.e., in addition to the 'usual' threats that would be faced by a professional accountant in public practice which are explained in the IESBA Code). These include:

- (a) A self-review or self-interest threat may arise from being a previous member of the engagement team, in particular the engagement partner, or being recently consulted on matters related to the engagement where areas of significant judgment exist.
 - (b) A familiarity or self-interest threat may arise when the EQC reviewer is a close or immediate family member of the engagement partner, or another key member of the engagement team, as well as in circumstances when close personal relationships are developed through long association with such personnel.
 - (c) An intimidation threat may arise in circumstances when a member of the engagement team, including the engagement partner is an aggressive or dominant individual, or the EQC reviewer is in the chain of command of a member of the engagement team, including the engagement partner.
10. The IESBA Code does not specifically discuss the above threats in the context of the EQC reviewer although, in the view of the IESBA, they are covered by the fundamental principles. However, the QCTF agrees that there is insufficient granularity in the IESBA Code in terms of specifically explaining how these threats may arise in the case of an EQC reviewer and how such a threat could be adequately safeguarded. As a result, absent such threats being explicitly addressed in the IESBA code, the QCTF is of the view that the application material supporting the requirements that address the objectivity of the EQC reviewer would need to explain these threats in order that firms consider whether, or how these apply, in evaluating the objectivity of the EQC reviewer. (See paragraphs A47f–A47i of Table 1)

Cooling-off period

11. The QCTF considered the circumstances when law, regulation or relevant ethical requirements do not explicitly prohibited a former engagement partner from fulfilling the role of an EQC reviewer. In particular, the QCTF identified that a self-review or self-interest threat may exist in such circumstances, and that without a requirement in place which prescribes a cooling-off period (i.e., the time that an individual who had previously served as engagement partner would not be eligible to fill the role of the EQC reviewer), EQC reviewers may not be sufficiently objective. Accordingly, the QCTF is of the view that a requirement needs to be established for a cooling-off period in respect of audits of financial statements in order to address the proper performance of the EQC review in the public interest. In relation to engagements other than audits of financial statements, the QCTF is of the view that the risk of a self-review or self-interest threat may vary depending on the circumstances of the engagement and establishing a fixed cooling-off period in relation to these other types of engagements may be inappropriate.
12. The QCTF considered whether such a requirement should be incorporated into ISQC 1, or whether it would be best addressed by IESBA. The QCTF observed that respondents to the ITC overall supported actions to address the cooling-off period, however there were mixed views as to whether it should be addressed by the IAASB, IESBA or both.
13. In relation to addressing familiarity threats to the EQC reviewer's independence, respondents to the IESBA's Exposure Draft, [*Limited Re-Exposure of Proposed changes to the Code Addressing the Long Association of Personnel with an Audit Client*](#) (Limited Re-ED), suggested locating the provisions relating to the long association of EQC reviewers with an audit client in ISQC 1. However,

the IESBA concluded that this would be inappropriate given that independence is within the remit of IESBA (see [Basis for Conclusions: Changes to the Code Addressing Long Association](#) (BFC)). Although a familiarity threat is different from a self-review or self-interest threat, the principles in relation to where provisions are located in the IESBA Code versus ISQC 1 are analogous and should be applied consistently.⁴ The QCTF further noted in the BFC that the IESBA committed to future coordination with the IAASB in respect of EQC reviewers on matters arising in relation to the review of ISQC 1.

14. The QCTF agreed that the requirement for a cooling-off period (i.e., that prohibits a person who served as an engagement partner on an audit of financial statements from filling the role of the EQC reviewer on that engagement) would be best placed in the IESBA Code. Given the planned discussion by the IESBA at their June 2017 meeting, the QCTF is of the view that further coordination with IESBA is needed before finalizing the requirements in relation to the cooling-off period. Nevertheless, members of the QCTF are of the view that the IAASB may need to pursue addressing the cooling-off period in ISQC 1, in light of the time it may take IESBA to undertake the changes to the IESBA Code if IESBA determines this to be the appropriate course of action. However, one member of the QCTF is of the view that ISQC 1 should not be used as a mechanism to address matters that are within the ambit of the IESBA Code, and that it should be left to IESBA to address, irrespective of the time it would take to do so.
15. In light of the QCTF's views that a cooling-off period should be established (either in ISQC 1 or the IESBA Code), the QCTF debated an appropriate period for the cooling-off period. The QCTF noted the requirement in the PCAOB's standard AS 7 that prescribes a 2 year cooling-off period. The QCTF is of the view that it is highly unlikely that a cooling-off period shorter than 2 years would be appropriate, because decisions that the engagement partner makes in an audit of financial statements usually has an effect for at least two years following that financial period. The QCTF also noted in IESBA's BFC that a period of 3 years was considered appropriate in relation to the cooling-off period for an EQC reviewer under the long association provisions because this would better ensure that the individual would be away from the audit engagement for a full 2 financials years, given the "hand-over" process that can occur at the end and beginning of an audit, thereby better supporting the "fresh look" principle.

Other Considerations

16. The QCTF noted the views of the Board that the function of the EQC reviewer needs to be reinforced, i.e., the EQC reviewer should critically evaluate and challenge the judgments, decisions and conclusions of the engagement team and the engagement team should evaluate how best to address the issues raised by the EQC reviewer. However, the engagement team should not rely on the EQC reviewer to make decisions and judgments. In circumstances when there are differences of opinion between the EQC reviewer and the engagement team, the firm would have established processes

⁴ In the Limited Re-ED, the IESBA noted the following in relation to a possible cooling-off period from being an engagement partner to an EQC reviewer: "The IESBA determined that if a cooling-off period is to be served before a key audit partner could become an EQC reviewer, this matter would be best addressed under ISQC 1. The IESBA noted that ISQC 1 already establishes requirements for the independence and objectivity of the EQCR". The QCTF noted that this conclusion was prior to the IESBA's conclusion on the appropriate location of the long association provisions addressing familiarity threats, which is a similar issue, and therefore it is evident that the IESBA's thinking on this has evolved since the Limited Re-ED.

for addressing differences of opinion. This concept is addressed in paragraph A49 of the extant ISQC 1 (the EQC reviewer does not make decisions for the engagement team), however further application material will be included to emphasize this. (See paragraph A47j of Table 1)

Matters for IAASB Consideration

2. The IAASB is asked to share their views in relation to the objectivity of the EQC reviewer, in particular:
 - (a) Does the IAASB agree with the QCTF's proposal to enhance the application material in relation to threats to objectivity that are unique to the EQC reviewer in the context of their role? (See paragraphs A47f–A47i of Table 1)
 - (b) Does the IAASB agree that a fixed cooling-off period needs to be established in respect of audits of financial statements?
 - (c) Is the IAASB of the view that ISQC 1 should include a cooling-off period if it is determined by the IESBA that the cooling-off period will not be incorporated into the IESBA Code within the foreseeable future?
 - (d) Does the IAASB have any views regarding the period of the cooling-off period, for example, should the approach of the PCAOB be followed (2 years), or would it be more appropriate to align with the IESBA provisions addressing the long association of the EQC reviewer (3 years)?

The Process for the Selection of the EQC Reviewer (Paragraphs 41 and A49–A50 of Table 1)

17. The IAASB agreed at the September 2016 meeting that the EQC review is a firm-level control that operates at an engagement level, and this has been incorporated into the proposed objective of an EQC review that was presented to the Board at its December 2016 meeting. Furthermore, the IAASB was of the view that members of the firm other than those involved in the engagement should select the EQC reviewer, given that the EQC review is a firm level control. However, this is not always possible, for example, in smaller firms where there are very few engagement partners. Under paragraph A49 of extant ISQC 1, the selection of the EQC reviewer is undertaken by the firm, *where practicable*. The QCTF proposes enhancing this by including a requirement that the EQC reviewer shall be selected by someone other than the engagement partner or other members of the engagement team unless in exceptional circumstances it is not possible, with application material explaining that, in circumstances when there is no one other than the engagement partner or a member of the engagement team to select the EQC reviewer, other mechanisms are established to safeguard the objectivity of the EQC reviewer. (See paragraphs 41b and A50 of Table 1)
18. The QCTF further recommends that the application material should explain how the requirements relating to the eligibility of the EQC reviewer would apply in circumstances when the firm selects an EQC reviewer outside from the firm. The QCTF noted the PCAOB's guidance contained in the overview section to the release of the Engagement Quality Review Standard⁵ in developing the application material proposed in paragraph A50 of Table 1.

⁵ https://pcaobus.org/Rulemaking/Docket%2025/2009-07-28_Release_No_2009-004.pdf

19. In addition, the QCTF is of the view that those responsible for selecting the EQC reviewer need to have sufficient knowledge to be able to assess whether individuals are eligible to perform the EQC review, which includes knowledge of the individuals as well as knowledge about the engagements that are subject to an EQC review. These qualities are essential in ensuring that the right person is performing the review. Accordingly, the QCTF proposes introducing a new requirement that sets out the qualities of the person assigned the function of selecting the EQC reviewer. (See paragraphs 41a and A49 of Table 1)

Matters for IAASB Consideration

3. Does the IAASB agree with the approach regarding the selection of the EQC reviewer, i.e.:
- (a) The person selecting the reviewer should be someone other than the engagement partner or other members of the engagement team, with an exception for circumstances when this is not practicable. (See paragraphs 41b and A50 of Table 1)
 - (b) Those responsible for selecting the EQC reviewer need to have sufficient knowledge to be able to assess whether individuals are eligible to perform the EQC review. (See paragraphs 41a and A49 of Table 1)

Table 1: Proposed Requirements and Application Material Addressing the Selection and Eligibility of the EQC reviewer (changes represent the “marked from extant”)

Requirements

Criteria for the Eligibility of Engagement Quality Control Reviewers

39. ~~The firm shall establish policies and procedures to address the appointment of engagement quality control reviewers and establish their eligibility through:~~ The firm’s policies and procedures that establish the criteria for the eligibility of the engagement quality control reviewer, shall be designed to enable the engagement quality control reviewer to provide an objective evaluation, in a timely manner at appropriate stages during the engagement, of the significant judgments made by the engagement team and the conclusions reached thereon. Such policies and procedures shall include that the engagement quality control reviewer: (Ref. Para: A46a–A46b)
- (a) Has sufficient technical competence, including knowledge of the entity’s industry, and capacity to be able to perform the role of engagement quality control reviewer for the particular engagement; (Ref. Para: A47–A47a and A47c–A47d) ~~The technical qualifications required to perform the role, including the necessary experience and authority; and (Ref: Para: A47);~~
 - (b) Has appropriate experience related to engagements of a similar nature and complexity, and in the case of an engagement quality control review for an audit of financial statements of a listed entity, appropriate experience related to an audit of financial statements of a listed entity; and (Ref. Para: A47b–A47d) ~~The degree to which an engagement quality control reviewer can be consulted on the engagement without compromising the reviewer’s objectivity. (Ref: Para: A48)~~
 - (c) Maintains their objectivity throughout the engagement, including complying with the requirements of law, regulation or relevant ethical requirements relating to objectivity, if any. (Ref.

Para: A47e–A47j) [Requirement to be further developed once further liaison with IESBA has taken place]

- ~~40. The firm shall establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. (Ref: Para. A49–A51)~~
- ~~404. If during the engagement the engagement quality control reviewer's objectivity may have become impaired or the engagement quality control reviewer's ability to perform the review is otherwise determined to be impaired, tThe firm's policies and procedures shall provide for the replacement of the engagement quality control reviewer where the reviewer's ability to perform an objective review may be impaired. (Ref: Para. A48)~~
- ~~41. The firm shall assign the responsibility for the appointment of the engagement quality control reviewer(s) to an engagement(s) to an individual(s) who: (Ref: Para. A49-A50)~~
- ~~(a) Possesses sufficient knowledge to be able to assess whether the individual(s) is eligible to perform the engagement quality control review; and~~
 - ~~(b) Is not part of the engagement team unless, in exceptional circumstances, it is not practicable.~~

Application Material

Criteria for the Eligibility of Engagement Quality Control Reviewers (Ref: Para. 39)

~~A46a. Policies and procedures establish the responsibilities of the engagement quality control reviewer in undertaking their review, and form the basis for their ability to confidently challenge the significant judgments made by the engagement team and the conclusions reached thereon. The audit firm's culture has an important influence on the values, ethics and attitudes of engagement partners and staff. A firm culture that fosters audit quality creates a culture where audit quality is valued and promotes the personal characteristics essential to audit quality, including where the engagement partner and engagement team have professional respect for the engagement quality control reviewer and consider the engagement quality control reviewer as a person who can raise appropriate challenges.~~

~~A46b. Other policies and procedures established by the firm may also help to promote a culture that respects the purpose of the engagement quality control review. For example, the firm's policies and procedures addressing differences of opinion and appropriate consultation may be useful in promoting such a culture and assigning responsibility for the oversight of the engagement quality control review process to a senior individual within the firm may also promote this culture.~~

~~Sufficient and Appropriate Technical Competence Expertise, Capacity and Experience and Authority (Ref: Para. 39(a)–39(b))~~

~~A47. What constitutes sufficient and appropriate technical expertise, experience and authority depends on the circumstances of the engagement. For example, the engagement quality control reviewer for an audit of the financial statements of a listed entity is likely to be an individual with sufficient and appropriate and experience and authority to act as an audit engagement partner on audits of financial statements of listed entities. The technical competence that is necessary to be able to perform the role of engagement quality control reviewer will depend on the circumstances of the~~

engagement. For example, technical competence may include an understanding of professional standards and applicable legal and regulatory requirements, specialized knowledge of areas of accounting or auditing or expertise with relevant information technology.

A47a. The policies and procedures addressing the capacity of the engagement quality control reviewer may include systems to monitor the workload and availability of the engagement quality control reviewers to enable the firm to make an assessment as to which individuals have sufficient time to adequately discharge their responsibilities.

A47b. In establishing the policies and procedures addressing the appropriate experience of the engagement quality control reviewer, the firm may take into consideration various factors, for example, the nature of the engagement and the entity, or the appropriate level of practical experience needed to be able to challenge the significant judgments made by the engagement team and the conclusions reached thereon (e.g., the individual has previously performed the role of engagement partner, engagement quality control reviewer or another senior role on a similar engagement).

A47c. The level of industry knowledge and experience that is sufficient to perform the role of engagement quality control reviewer depends on the engagement and the nature of the industry. For example, certain industries are highly specialized and have more complex accounting practices and would require greater industry expertise.

A47d. The policies and procedures addressing the eligibility of the engagement quality control reviewer may set out additional considerations in relation to the technical competency and experience of the engagement quality control reviewer. For example, such policies may take into consideration the inspection results or other performance ratings related to engagement quality of the engagement quality control reviewer.

Objectivity of the Engagement Quality Control Reviewer (Ref: Para. 39(c))

[The application material below provides an example of possible matters that may be included in the application material, however may require alteration once further liaison with IESBA has taken place.]

A47e. Paragraph 20 *[of extant ISQC 1]* requires the firm to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. The IESBA Code establishes the fundamental principles of professional ethics, including objectivity. In complying with the fundamental principles, the engagement quality control reviewer may be subject to threats that may affect their objectivity, including self-review threats, self-interest threats, familiarity threats, advocacy threats and intimidation threats. The IESBA Code provides examples of safeguards that may be appropriate to address such threats.

A47f. Threats to the objectivity of the engagement quality control reviewer may arise in relation to the client engagement or engagement team, through a self-review, self-interest, familiarity or intimidation threat. For example, the IESBA Code discusses self-interest and familiarity threats that may arise as a result of long association as a member of the engagement team, including in the role of engagement quality control reviewer, in the context of:

- The entity, its operations or senior management; or

- The subject matter and subject matter information of the engagement (e.g., the financial statements on which the firm will express an opinion or the financial information which forms the basis of the financial statements).

Law, regulation or relevant ethical requirements may establish requirements that prohibit an individual who previously served as engagement partner from being eligible to perform the engagement quality control review for a certain period. For example, the IESBA Code contains requirements addressing the long association of senior personnel with a client that may prohibit an individual from performing the role of engagement quality control reviewer when the individual has served as the engagement partner or engagement quality control reviewer in relation to the engagement for a particular period of time.⁶

A47g. Examples of circumstances that may create a self-review, self-interest, familiarity or intimidation threat in respect of the engagement quality control reviewer's association with the engagement team include:

- (a) A self-review or self-interest threat may arise from being a previous member of the engagement team, in particular the engagement partner, or being recently consulted on matters related to the engagement where areas of significant judgment exist.
- (b) A familiarity or self-interest threat may arise when the engagement quality control reviewer is a close or immediate family member of the engagement partner, or another key member of the engagement team, as well as in circumstances when close personal relationships are developed through long association with such personnel.
- (c) An intimidation threat may arise in circumstances when a member of the engagement team, including the engagement partner is an aggressive or dominant individual, or the engagement quality control reviewer is in the chain of command of a member of the engagement team, including the engagement partner.

A47h. Examples of safeguards that may be appropriate in addressing intimidation threats to the engagement quality control reviewer's objectivity, include:

- (a) Designating a member of firm leadership to be responsible for overseeing the adequate functioning of the firm's policies and procedures related to engagement quality control reviews, or having the appointment of the engagement quality control reviewer approved by a member of firm leadership.
- (b) Establishing robust processes for addressing differences of opinion or establishing policies and procedures to encourage and empower the engagement quality control reviewer to communicate to senior levels within the firm any issue relating to the performance of the engagement quality control review.
- (c) Utilizing an engagement quality control reviewer from another network firm or region who is outside the chain of command of the engagement partner or other member of the engagement team.

⁶ See, for example, Section 290 and 291 of the IESBA Code.

A47i. In some circumstances, it may not be possible to eliminate or reduce to an acceptable level a self-review, familiarity or intimidation threat and therefore the firm will determine that the individual is not eligible to be appointed as the engagement quality control reviewer. In circumstances when there are no suitable individuals to perform the engagement quality control review within the firm, the firm may contract suitably qualified external persons to perform the engagement quality control review or the firm may use other firms to perform the review.

A47j. Paragraph 39(c) requires that the engagement quality control reviewer maintains their objectivity throughout the engagement. For example, in performing the engagement quality control review, the engagement quality control reviewer evaluates the significant judgments of the engagement team; the engagement team would consider how best to address the matters raised by the engagement quality control reviewer but the engagement quality control reviewer does not make such judgments.

Consultation with the Engagement Quality Control Reviewer (Ref: Para. ~~4039(b)~~)

A48. The engagement team, including the engagement partner, may consult the engagement quality control reviewer during the engagement, for example, to establish that a judgment made by the engagement ~~partner~~ team will be acceptable to the engagement quality control reviewer. Such consultation avoids identification of differences of opinion at a late stage of the engagement and need not compromise the engagement quality control reviewer's eligibility to perform the role. Where the nature and extent of the consultations become significant the reviewer's objectivity may be compromised unless care is taken by both the engagement team and the reviewer to maintain the reviewer's objectivity. Where this is not possible, another individual within the firm or a suitably qualified external person may be appointed to take on the role of either the engagement quality control reviewer or the person to be consulted on the engagement.

Assessment of the Eligibility of the Engagement Quality Control Reviewer (Ref: Para. 41)

A49. The role of the person(s) within the firm who is assigned responsibility for the assessment of whether the individual(s) is eligible to perform the engagement quality control review will vary from firm to firm. The complexity of the firm's process may depend on a number of factors, for example, the structure of the firm and its size, whether the firm is a network firm, its geographical dispersion and the range of services it provides. Sufficient knowledge to be able to assess the eligibility of the potential engagement quality control reviewer includes an appropriate knowledge of the engagement subject to engagement quality control review, as well all of the criteria set out in paragraph 39 in relation to the engagement quality control reviewer.

A50. In certain circumstances, it may not be practicable for an individual, other than a member of the engagement team, to appoint the engagement quality control reviewer. In such cases, the firm may establish other procedures to safeguard the engagement quality control reviewer's objectivity, for example, the firm may contract suitably qualified external persons or other firms to perform the engagement quality control review. In circumstances when the firm contracts suitably qualified external persons to perform engagement quality control reviews or uses other firms to perform the review, the firm may need to make inquiries to obtain necessary information about whether the individuals charged with performing the reviews comply with all the criteria set out in paragraph 39. In these

circumstances, the engagement team may consider documenting their evaluation of the objectivity of the engagement quality control reviewer, in order to evidence that the objectivity was considered appropriate.

~~Objectivity of the Engagement Quality Control Reviewer (Ref: Para. 40)~~

~~A49. The firm is required to establish policies and procedures designed to maintain objectivity of the engagement quality control reviewer. Accordingly, such policies and procedures provide that the engagement quality control reviewer:~~

- ~~• Where practicable, is not selected by the engagement partner;~~
- ~~• Does not otherwise participate in the engagement during the period of review;~~
- ~~• Does not make decisions for the engagement team; and~~
- ~~• Is not subject to other considerations that would threaten the reviewer's objectivity.~~

~~Considerations specific to smaller firms~~

~~A50. It may not be practicable, in the case of firms with few partners, for the engagement partner not to be involved in selecting the engagement quality control reviewer. Suitably qualified external persons may be contracted where sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. Where the firm contracts suitably qualified external persons, the requirements in paragraphs 39–41 and guidance in paragraphs A47–A48 apply.~~

~~Considerations specific to public sector audit organizations~~

~~A51. In the public sector, a statutorily appointed auditor (for example, an Auditor General, or other suitably qualified person appointed on behalf of the Auditor General) may act in a role equivalent to that of engagement partner with overall responsibility for public sector audits. In such circumstances, where applicable, the selection of the engagement quality control reviewer includes consideration of the need for independence from the audited entity and the ability of the engagement quality control reviewer to provide an objective evaluation.~~

Appendix 1

Consideration of How the Principles in the IESBA Code relate to the Objectivity of the EQC Reviewer

1. Paragraph R110.2⁷ of the proposed restructured IESBA Code⁸ (paragraph 100.5 of the extant IESBA Code) requires a professional accountant to comply with the fundamental principles set out in the IESBA Code, which includes objectivity.⁹ In complying with these fundamental principles, paragraph R120.6¹⁰ (new explicit requirement derived from paragraph 100.6 and 290.1 of the extant IESBA Code) requires professional accountants to identify threats to compliance with the fundamental principles, which may include self-review threats, self-interest threats, familiarity threats, advocacy threats and intimidation threats. For the purposes of this discussion, the focus is on self-review threats, self-interest threats and familiarity threats that may arise in the context of the EQC reviewer's role when performing the EQC review. Nevertheless, the EQC reviewer has a responsibility to apply all of the principles of the IESBA Code.

⁷ Proposed restructured Code Part 1 – Complying with the Code, Fundamental Principles and Conceptual Framework, Section 110, *The Fundamental Principles*

⁸ In January 2017, the IESBA announced the completion of the major first phase of its strategic project to restructure the IESBA. The proposed restructured IESBA Code would be retitled International Code of Ethics for Professional Accountants (Including International Independence Standards).

The IESBA also released three exposure drafts (EDs) with new proposals that will enhance and complete the fully restructured IESBA Code with strengthened ethics requirements for professional accountants. Highlights of the main improvements to date, including details of how the different work streams are being coordinated and related timelines, are set out in the January 2017 publication, [IESBA Update: Toward a Restructured International Code of Ethics](#).

IESBA has also made available on its [website](#) the restructured and revised portions of the IESBA Code it has agreed to so far. These, together with a Staff-prepared [Compilation of Proposed Restructured IESBA Code](#), Basis for Conclusions documents, mapping tables, and other resources, are intended to support stakeholders' timely adoption and implementation efforts, and consideration of the January 2017 EDs.

The Staff-prepared Compilation of Proposed Restructured IESBA Code combines the [agreed-in-principle texts](#) for Phase 1 of the Structure and Safeguards projects and the proposed texts relating to the [Structure ED-2, Improving the Structure of the Code of Ethics for Professional Accountants—Phase 2](#), [Safeguards ED-2, Proposed Revision Pertaining to Safeguards in the Code—Phase 2 and Related Conforming Amendments](#), and the [Applicability ED, Proposed Revisions to Clarify the Applicability of Provisions in Part C of the Extant Code to Professional Accountants in Public Practice](#). The comment deadlines for comments are May 25, 2017 for the Structure ED-2 and April 25, 2017 for the Safeguards ED-2 and Applicability ED.

The references to the IESBA Code in this paper are to the proposed restructured IESBA Code (i.e., the sections or paragraphs in the Staff-prepared Compilation of Proposed Restructured Code). Furthermore, for the purposes of clarity, the references to the existing requirements of the IESBA Code have also been included in brackets and **grey text**.

⁹ Paragraph 110.1 of the proposed restructured IESBA Code defines objectivity as “not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others”.

¹⁰ Proposed restructured Code Part 1, Section 120, *The Conceptual Framework*

Familiarity threats

2. A familiarity threat is described in paragraph 120.6 A3 (d) of the IESBA Code (paragraph 110.12 (d) of the extant IESBA Code) as “the threat that due to a long or close relationship with a client, or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work”. Sections 540¹¹ (paragraphs 290.148-290.168 of the extant IESBA Code) and 940¹² (partially new requirement, partially restructured from section 291.137 of the extant IESBA Code) of the IESBA Code, which contain the provisions relating to the long association of personnel, address familiarity threats for professional accountants in public practice (PAPPs) performing audits and reviews of financial statements or other assurance engagements in relation to:
 - The client;
 - In the case of an audit, the client's operations and senior management; or
 - The subject matter (financial statements) or subject matter information (financial information which forms the basis of the financial statements), i.e., the engagement.
3. For audits of public interest entities, Section 540 of the IESBA Code (paragraphs 290.148-290.168 of the extant IESBA Code) contains requirements and application material that prescribe the maximum period that an individual may serve on the engagement, including as EQC reviewer, as well as minimum cooling-off periods, that are intended to address such familiarity and self-interest threats. During the cooling-off period, an individual is prohibited from being involved in the client, including performing the role of EQC reviewer. However, Section 540 (paragraphs 290.148-290.168 of the extant IESBA Code) does not address the circumstances when the individual switches between various roles during the time-on period, for example, an individual is permitted to serve a maximum of 7 years and therefore may fulfill the role of engagement partner for 4 years and switch to the EQC reviewer for 3 years. In respect of audits of entities that are not public interest entities, the conceptual framework set out in Section 120 of the IESBA Code would apply to identifying, evaluating and addressing threats created from long association (see introduction paragraphs in Sections 540). Accordingly, although the long association provisions may prevent the engagement partner from fulfilling the role of EQC reviewer in certain circumstances in order to address a familiarity or self-interest threat, there are circumstances that may arise when this is not explicitly prohibited.
4. Furthermore, the long association provisions address familiarity threats in relation to the client, its management and the engagement. However, Sections 540 (paragraph 290.148-290.168 of the extant IESBA Code) and 940 (partially new requirement, partially restructured from section 291.137 of the extant IESBA Code) do not include provisions to deal with familiarity threats that may be created from situations that exist within the firm (e.g., the EQC reviewer is a close family member of the engagement partner).

¹¹ Proposed restructured Code Part 4A – Independence for Audits and Reviews, Section 540, *Long Association of Personnel (Including Partner Rotation) with an Audit Client*

¹² Proposed restructured Code Part 4B – Independence for Other Assurance Engagements, Section 940, *Long Association of Personnel with an Assurance Client*

5. As highlighted above, paragraph 120.6 A3 (d) of the IESBA Code (100.12 (d) of the extant IESBA Code) describes familiarity threats in the context of the “relationship with a ... employer”. The Applicability ED contains proposals¹³ to clarify that the provisions in Part C of the extant IESBA Code (i.e., those applicable to professional accountants in business (PAIB)) might be applicable to PAPPs in ethical situations not involving clients. Paragraph 200.6 A1 of the IESBA Code (paragraph 300.11 of the extant IESBA Code) provides examples of facts and circumstances that might create familiarity threats for a PAIB, in the context of the relationship with an employer (e.g., a professional accountant being responsible for the financial reporting of the employing organization when an immediate or close family member employed by the organization makes decisions that affect the financial reporting of the organization). Similarly paragraph 200.6 A1 (paragraph 300.11 of the extant IESBA Code) also contains examples of facts or circumstances that might create intimidation threats that may be relevant to an EQC reviewer. These examples may help provide guidance for EQC reviewers in dealing with familiarity threats that may be created within the engagement team (e.g., the EQC reviewer is a close family member of the engagement partner).
6. In essence, the IESBA (the IESBA Staff, and certain members of the IESBA Board) are of the view that a familiarity threat in relation to the client, its management, the engagement or the engagement team is addressed in the IESBA Code. While certain sections of the IESBA Code provide explicit requirements and application material for addressing familiarity threats (e.g., the long association provisions for audits of public interest entities), the application of the conceptual framework is relevant for other circumstances (specifically paragraphs R120.10–120.10 A2 (paragraph 100.9 of the extant IESBA Code)). However, the QCTF concur that the IESBA Code does not provide appropriate granularity in terms of specifically explaining how a familiarity threat in relation to the engagement team may arise in the circumstance of an EQC reviewer and how such a threat could be adequately safeguarded.

Self-review or Self-interest Threats

7. A self-review threat is described in paragraph 120.6 A3 (b) of the IESBA Code (paragraph 100.12 (b) of the extant IESBA Code) as “the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made, or an activity performed by the accountant, or by another individual within the accountant’s firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity”. A self-interest threat is described in paragraph XXXX of the IESBA Code (paragraph 100.12 (a) of the extant IESBA Code) as “the threat that a financial or other interest will inappropriately influence the professional accountant’s judgment or behavior”.
8. In the case of an EQC reviewer, a self-review or self-interest threat may arise as a result of the EQC reviewer being previously involved in the engagement. For example, after serving as the engagement partner on an audit of financial statements, the objectivity of the individual may be impaired in subsequent financial periods in relation to areas of the engagement where the individual exercised

¹³ Paragraph R300.5 of the IESBA Code indicates that “where a PAPP is performing professional activities pursuant to the accountant’s employment or ownership relationship with the firm, there might be requirements and application material in Part 2 [Proposed restructured Code, Part 2, Section 200, *Application of Conceptual Framework – Professional Accountants in Business*] that are also applicable to those circumstances. If so, the PAPP shall comply with the relevant provisions”.

significant judgment, due to the fact that the judgments made in one financial period may have relevance in succeeding financial periods. The IESBA is of the view that this situation is covered by the IESBA Code through the application of the conceptual framework. However, the QCTF concur that the IESBA Code does not provide appropriate granularity in terms of specifically explaining how a self-review or self-interest threat that may arise in the circumstance of an EQC reviewer and how such a threat could be adequately safeguarded.

Appendix 2

Extract of Minutes – IAASB 2016 September Meeting

SELECTION OF THE EQC REVIEWER

The Board supported the recommendations of the QCWG as they relate to improving the robustness of the selection of the EQC reviewer, although cautioned that these should not be overly prescriptive resulting in firms having limited suitable resources who are able, or willing, to fulfill the role. The Board was of the view that the selection of the EQC reviewer should be at firm level, rather than the engagement level, given that the EQC review is a firm level control. The Board provided the following additional matters for consideration:

- Emphasizing that the EQC reviewer should have the appropriate authority and status within the firm to enable them to confidently challenge the significant judgments.
- Addressing the appropriateness of the EQC reviewer's practical experience, for example, circumstances when the EQC review is delegated to a technical resource with limited practical experience.
- Reinforcing that the function of the EQC reviewer is not to override the judgments of the engagement team, but rather for the EQC reviewer to challenge those judgments and for the engagement team to evaluate how best to address the issues raised by the EQC reviewer.
- Addressing the capacity of the EQC reviewer to perform the review, i.e., their time available.
- Carefully addressing the appropriate skills of the EQC reviewer.

The Board was supportive of further liaison with the IESBA on the issue relating to the 'cooling-off' period between serving as the engagement partner and the EQC reviewer, although mixed views were expressed regarding whether a prescriptive period should be established. Those in support of a fixed period suggested 3 years or 5 years and indicated that it would prevent inconsistent application by firms, whereas those not supportive of a fixed period were of the view that there is no proper basis for establishing a fixed period.

IAASB CAG CHAIRMAN'S REMARKS

Mr. Waldron noted that the EQC review is a topic that is important to CAG Representatives and generated mixed views and significant interest for some. He highlighted the importance of taking into consideration how the EQC reviewer is assigned, as well as the network's role in EQC reviews, where applicable. Mr. Waldron specifically noted the CAG's comments about the importance of the timing of when the EQC review is undertaken.

WAY FORWARD

The QCWG will consider the Board's comments in further developing changes to EQC reviews, and will present their further recommendations to the Board at its December 2016 meeting on the matters discussed at the September 2016 meeting, as well as the nature, timing and extent of the EQC review.



Meeting: IAASB
Meeting Location: Lima, Peru
Meeting Date: March 13–17, 2017

Agenda Item 6

Quality Control (Firm Level) – Eligibility of the Engagement Quality Control Reviewer — Issues and Task Force Recommendations

Objective of Agenda Item

1. The objective of this Agenda Item is to obtain the IAASB's input on the Quality Control Task Force (QCTF's) recommendations in relation to the eligibility of the engagement quality control (EQC) reviewer, in response to the IAASB's feedback at the September 2016 meeting.

QCTF

2. The QCTF comprises the following members:
 - Karin French, IAASB Member and Chair of the WG (supported by Sara Ashton, IAASB Technical Advisor)
 - Bob Dohrer, IAASB Member (supported by Ahava Goldman, IAASB Technical Advisor)
 - Brendan Murtagh, IAASB Member
 - Imran Vanker, IAASB Member
 - Josephine Jackson, IAASB Technical Advisor
 - Denise Weber, IAASB Technical Advisor
 - Dawn McGeachy, IFAC Small and Medium Practices Committee Representative (correspondent member)
 - Keith Wilson, United States Public Company Accounting Oversight Board (official observer)

Activities of the QCTF

3. The QCTF has had two physical meetings and two teleconferences since the December 2016 IAASB meeting. The discussions of the QCTF included various topics related to quality management, such as governance and leadership, information and communication and monitoring and remediation. While the QCTF continues to make good progress on the project, it was determined that the issues and Task Force recommendations would not be presented to the IAASB at their upcoming March 2017 meeting. This was largely due to the QCTF's view that in order for the IAASB to provide effective feedback, the IAASB would need a full understanding of the various components comprising the firm's system of quality management. Furthermore, due to the integrated nature of the components, the QCTF agreed that more time is needed to develop the proposals in relation to each of the components.
4. In addition to these topics, the QCTF also considered how the standards could address circumstances when functions are performed at a network level that may help support the firm's

system of quality management. These considerations were undertaken in conjunction with the Group Audits Task Force and ISA 220 Task Force and the recommendations will be presented to the IAASB at a later stage. The Task Forces will continue to coordinate on this and other topics that affect all three projects, through Staff liaison and the common membership of Task Force members on the respective Task Forces.

5. As highlighted in **Agenda Item 6–A**, the objectivity of the EQC reviewer is closely related to the International Ethics Standards Board for Accountants (IESBA) *Code of Ethics for Professional Accountants* (the Code), given that objectivity is one of the fundamental principles addressed in the IESBA Code. Accordingly, since the December 2016 IAASB meeting, the IAASB Staff, IESBA Staff, Chair of the QCTF and certain members of the IESBA Board have coordinated on how the IESBA Code addresses the objectivity of the EQC reviewer and the various threats to the objectivity that may arise in the context of the EQC reviewer's role.

Matters for IAASB Consideration

6. **Agenda Item 6-A** presents the discussions and views of the QCTF, as well as the matters for IAASB consideration. The IAASB is asked to consider the matters as set out in the agenda item and provide input to assist the QCTF in progressing the changes to EQC reviews.

Material Presented

Agenda Item 6-A

Eligibility of the Engagement Quality Control Reviewer — Issues and Task Force Recommendations



Meeting: IAASB
Meeting Location: Lima, Peru
Meeting Dates: March 13–17, 2017

Agenda Item 3

Update on Coordination with other Standard Setting Boards

Objective of Agenda Item

1. The objectives of this agenda item are to:
 - Update the Board on actions taken to further enhance the coordination with other Standard Setting Boards (SSBs); and
 - Provide the Board with an overview of the SSB Staff's assessment to date of possible matters where further coordination may be needed.

Background

2. At the June 2016 IAASB Meeting, the Board received an update on the preliminary thinking related to enhancing the process of coordination between the SSB. This included a more systematic and structured process for coordination, featuring a mechanism to inventory, capture and manage coordination issues, early assessment of type of coordination required, periodic oversight review by Chairs jointly, and periodic Board updates. The Board was generally supportive of the proposals, but emphasized the need for the process to be flexible and not cumbersome and facilitate the identification and communication of issues in a timely manner.
3. Since then, the SSB Staff have met on various occasions to discuss:
 - How effective coordination could be operationalized at the Staff, Task Force / Working Group and Board levels in an efficient manner.
 - Compiling an inventory of matters that could have implications for other SSB.

This has resulted in the development of an inventory of matters of mutual interest across the three SSB, with the purpose of ensuring that these matters are effectively and appropriately addressed. However, although significant progress has been made in compiling an inventory of matters of mutual interest, the SSB Staff need to undertake further work in order to refine this compilation and ensure that all matters are considered and accurately reflected.

International Ethics Standards Board for Accountants (IESBA) Update

4. In January 2017, the IESBA announced the completion of the major first phase of its strategic project to restructure the Code of Ethics *for Professional Accountants* (IESBA Code). At the same time, the IESBA also released three exposure drafts with new proposals that will enhance and complete the fully restructured IESBA Code with strengthened ethics requirements for professional accountants.
5. The interrelationship of these projects and how they will be coordinated is complex. Accordingly, in January 2017, the IESBA published an overview of the main improvements to the IESBA Code that have been made to date, including details of how the different work streams are being coordinated

and related timelines, which is available in **Agenda Item 3-A**. This document may be useful to the IAASB in understanding where the IESBA is currently in their process, but is not otherwise for discussion.

Material Presented

Agenda Item 3-A

IESBA Update: Toward a Restructured International Code of Ethics

Matter for IAASB Consideration

1. The IAASB is asked to consider the presentation and discuss relevant aspects as appropriate.