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Guide to: **ISA 540 (Revised)** **Auditing Accounting Estimates and Related Disclosures**

A summary of the major changes of the impacts for audits of financial statements for periods starting on or after 15 December 2019

Background

In December 2018 Financial Reporting Council published issued revisions to International Standard on Auditing (ISA) (UK) 540 'Auditing Accounting Estimates and Related Disclosures' which are effective for audits of financial statements for periods beginning on or after 15 December 2019.

The revisions have been made to address recent changes to financial reporting standards and requirements, such as changes to IFRS standards dealing with insurance contracts, revenue recognition and leases, as well as to address audit quality issues in this complex area.

Changes

The revisions to the standard focus on ensuring auditors complete their work with due professional scepticism while improving communications and transparency between the auditor and those charged with governance.

The revisions introduce various new requirements, amendments and enhancements including

- Enhanced risk assessment procedures and requirements for separate inherent risk and control risk assessments and the introduction of the concept of the spectrum of inherent risk;
- Enhanced emphasis on the auditor's review of relevant controls over accounting estimates;
- A requirement for further audit procedures to respond to the assessed risks of material misstatement – the higher the assessed risk the more persuasive the audit evidence needs to be;
- Increased levels of audit work around testing methods, data and assumptions used by management in making estimates;
- Increased audit documentation requirements;
- A new "overall stand-back" requirement; and
- Increased audit requirements for disclosures

Risk assessment changes

The revised standard requires auditors to perform separate inherent risk and control risk assessments to form the basis for designing and performing further audit procedures to respond to the risks of material misstatement.

In recognition that all risks are not equal, the revised standard also introduces a new concept of the "spectrum of inherent risk". Where the assessed risk falls on the spectrum will determine what further audit procedures auditors will need to perform. Ultimately, the higher on the spectrum the risk falls, the more persuasive the audit evidence needs to be.

These risk assessments will be based on auditors' understanding of the entity, its environment and internal control. As part of understanding internal control, auditors are required to review and document the outcome of previous accounting estimates. This is important as it helps auditors to make judgements about management's track record in making estimates and assists in identifying and assessing the risks of material misstatement in the current period.

The revised standard introduces and formalises the idea of 'inherent risk factors'. The three key ones that the standard addresses are:

- estimation uncertainty: susceptibility to an inherent lack of precision in the measurement of an estimate;
- subjectivity: inherent limitations in the data or knowledge that is reasonably available about valuation attributes; and
- complexity: the complexity inherent in the process of making an accounting estimate

So, the auditors' assessment of inherent risk will depend on the degree to which these risk factors affect the likelihood or magnitude of misstatement.

Scepticism

Because of repeated calls from regulators in recent years for auditors to be more sceptical on audits and given the extent of complexity, uncertainty and judgement involved in making some accounting estimates, this is an area of focus for the revised standard.

The revised standard requires that audit work is designed and performed by the auditor to be balanced so it is not biased towards obtaining corroborative evidence or towards excluding contradictory evidence. Auditors shouldn't just look for supporting evidence but equally don't just keep pursuing a line of questioning for no reason.

Enhanced application of professional scepticism is also introduced through the "stand-back" requirement. Auditors are required to ask themselves whether, based on the procedures performed:

- the risk assessments at the assertion level are appropriate;
- management's decisions relating to recognition, measurement and presentation and disclosures are in accordance with the financial reporting framework; and
- sufficient appropriate audit evidence has been obtained

The "stand-back" requirement allows auditors to reflect on work performed, the appropriateness of the risk assessments and whether they have obtained unbiased sufficient appropriate audit evidence in total.

Documentation

ISA 540 (Revised) specifically requires audit documentation to include:

- the key elements of the auditor's understanding of the entity and its environment, including internal control relating to accounting estimates;
- the response to situations where management has not taken appropriate steps to understand and address estimation uncertainty;
- indicators of possible management bias, if any, and the auditor's evaluation of the implications for the audit; and
- significant judgements made in the determination of whether the accounting estimates and related disclosures are reasonable, or are misstated, in the context of the applicable financial reporting framework.

Auditors will have to document how they have exercised professional scepticism throughout the audit to their conclusions, including the challenges and judgements they made along the way.

Conclusions

The new requirements are designed to be "scalable" and should be less onerous for audits of financial statements where there are few areas requiring accounting estimates. For those audits at the other end of the spectrum where entities include several complex accounting estimates in their financial statements there will undoubtedly and increased level of audit work on these estimates.

Management may find themselves answering more searching or detailed questions from auditors than previously and may be asked to corroborate and provide more detailed or greater volumes of evidence to support the judgements and assumptions they have made when making accounting estimates.

To meet the increased requirements and regulations in an efficient and timely manner, auditors should liaise with management and finance teams early in the audit planning process to set out the detailed requirements of the audit plan and the necessary deliverables from the client. Management should prepare in advance and be ready to provide support and evidence for all material elements of the estimates made in the course of the financial reporting process.