



Crowe Chat

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Accounting and Audit

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Table of Contents

Alert on International Standard on Auditing (ISA) 540 (Revised), *Auditing of Accounting Estimates and Related Disclosures*

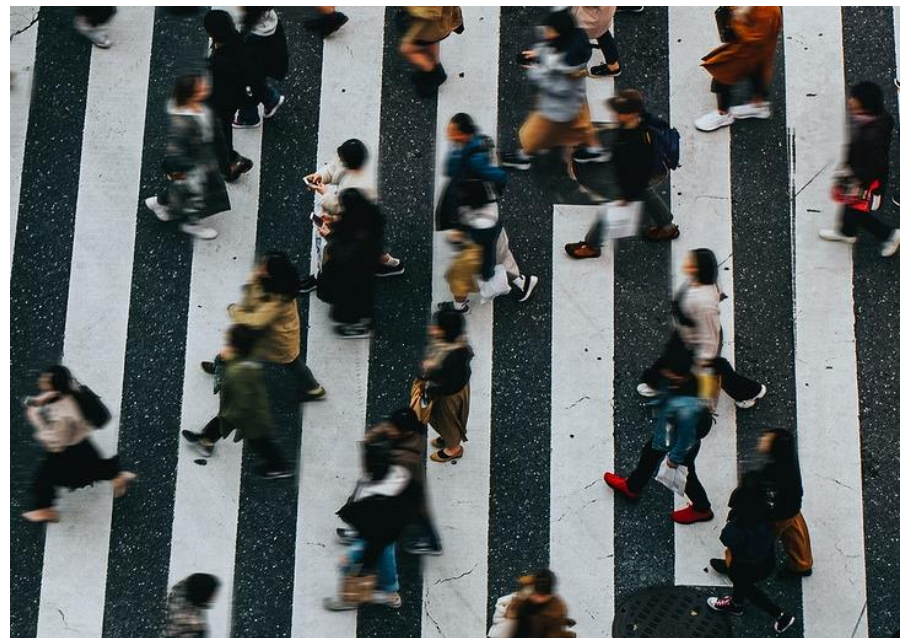
- 01 | Introduction**
- 02 | Key Enhancements**
- 03 | Overall Implications**
- 04 | Details of ISA 540**
- 05 | At a Glance**
- 06 | Effective Date**

Alert on International Standard on Auditing (ISA) 540 (Revised), *Auditing of Accounting Estimates and Related Disclosures*

1. Introduction

Accounting is not as exact as you think. In many instances, estimation of a judgmental nature is involved. As a result, the International Auditing and Assurance Standards Board (IAASB) has issued ISA 540 as guidance to accountants and auditors alike. ISA 540 deals with the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements.

The IAASB published the revised ISA 540 in 2018 and this revised standard is effective for audits of financial statements for periods beginning on or after 15 December 2019. This ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*, is enhanced to better address the public interest issues associated with accounting estimates.



2. Key Enhancements

The revised ISA 540 establishes more robust requirements and appropriately detailed guidance to foster audit quality by driving auditors to perform appropriate procedures relating to accounting estimates. The key enhancements are:



a) Objective-based work effort directed to methods, assumptions and data



c) Enhanced evaluation requirements to determine if related disclosures are reasonable



e) “Stand-back” requirement and evaluation of external information sources



b) The importance of auditor's decisions about controls and separate assessment of inherent risk and control risk



d) Enhanced risk assessment procedures including the concept of spectrum of inherent risk and focus on management bias in risk assessment



f) Enhanced requirement when communicating with those charged with governance

3. Overall Implications

Accounting estimates are increasingly common in financial statements and by its nature, caused an audit to be not easy. The changes in financial reporting such as changes in accounting for expected credit losses and revised IFRS standards dealing with revenue recognition, leases and insurance contracts, increase the awareness of accounting estimates to the users of financial statements.

Auditors need to review the estimates prepared by the management and challenge the basis of conclusions wherever necessary to determine if the accounting estimate used is reasonable. On the other hand, preparers need to prepare the basis of their accounting estimates in more detail and to substantiate these details with documentation and justifications.



4. Details of ISA 540 (Revised) (cont'd)

d) Risk Assessment

In tandem with the degree of complexity in accounting estimates, the assessment of inherent risk varies on a scale which is now referred to as the spectrum of inherent risk. In this respect, the relative degrees of the likelihood and magnitude of a possible misstatement play an important role. For example, the higher the combination of likelihood and magnitude, the higher the inherent risk is and the more persuasive the audit evidence needs to be. Accordingly, this will result in more targeted audit procedures on sources of potential misstatement within the accounting estimate.



e) “Stand-back” requirement & External information sources

Auditors should design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory. The testing of the completeness and accuracy of internally generated data remains essential. Auditors should evaluate the relevance and reliability of external information sources and management experts.



f) Communication

The Standard requires auditors to communicate with those charged with governance, regulators and prudential supervisors, if required by law, about significant qualitative aspects of the entity’s accounting practices. If the auditor’s consideration of estimation uncertainty associated with an accounting estimate and its related disclosures is a matter that requires significant auditor attention, then this may constitute a key audit matter.



4. Details of ISA 540 (Revised)

The major changes in the ISA 540 (Revised) compared to the original version are as follows:

a) Methods, Assumptions and Data

When different methods result in significantly different estimates, auditors should question and challenge the reasons for the reporting entity's choice of method and evaluate the appropriateness of the selection and whether the selection could be indicative of management bias. On the other hand, management should establish controls to prevent or detect bias in their selection of assumptions.



b) Management's Process

Auditors need to obtain an understanding of management's process including management's methods and/or models, the data and assumptions used, the validity of sources and the extent to which management uses experts. Preparers should look into the controls related to accounting estimates especially when there are alternative methods or a wide range of potential assumptions or multiple sources of data that could be used when making an accounting estimate.



c) Disclosures

Auditors should obtain audit evidence about the disclosures related to accounting estimates to determine whether the disclosures are "reasonable" (was previously whether disclosures are "adequate") in the context of the applicable financial reporting framework.



5. At a Glance

Overall, the revised ISA 540 is enhanced to address the audit quality for accounting estimates by fostering a more independent and skeptical mindset in auditors.

The diagram shown at the right pinpoints the areas where auditors should appropriately exercise the professional skepticism.

How does ISA 540 (Revised) enhance the auditor's exercise of professional skepticism?

A requirement to design and perform further audit procedures in a manner that is not biased towards obtaining audit evidence that may be corroborative or towards excluding audit evidence that may be contradictory

Requirement to “stand back” and evaluate the audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence

Use of stronger language (“challenge”, “question” and “reconsider”) in application material to reinforce the importance of exercising professional skepticism

Focus on management bias in risk assessment (other inherent risk factors include misstatement due to management bias or fraud) and work effort

Source: IAASB

6. Effective Date

The ISA 540 (Revised) is effective for audits of financial statements for periods beginning on or after 15 December 2019.



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