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Explanatory Memorandum
Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures; and Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards

Issued by the Auditing and Assurance Standards Board



Australian Government

Auditing and Assurance Standards Board

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Explanatory Memorandum *Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures*; and *Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards*

Important Note and Disclaimer

This Explanatory Memorandum is issued by the AUASB to provide information to auditors and assurance practitioners about the AUASB's implementation in Australia of the IAASB's revised ISA 540 *Auditing Accounting Estimates and Related Disclosures* as well as consequential and conforming changes arising from the proposed revision.

This Explanatory Memorandum does not establish or extend the requirements under an existing AUASB Standard(s) and is not intended to be a substitute for compliance with the relevant AUASB Standards with which auditors and assurance practitioners are required to comply when conducting an audit or other assurance engagement. No responsibility is taken for the results of actions or omissions to act on the basis of any information contained in this document or for any errors or omissions in it.

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EXPLANATORY MEMORANDUM

Exposure Draft 03/18: Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures; and Exposure Draft 04/18: Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards

Purpose

1. The aim of this Explanatory Memorandum is to provide constituents with information about Exposure Draft ED 03/18 and Exposure Draft ED 04/18, issued on 6 August 2018, and the Auditing and Assurance Standards Board's (AUASB) approach to implementing in Australia, the IAASB's ISA 540 *Auditing Accounting Estimates and Related Disclosures* (ISA 540), as well as consequential and conforming changes arising from the proposed revision.

Exposure Draft Questions

2. The AUASB is especially interested in constituents' views on:
 - (a) Have applicable laws and regulations been appropriately addressed in the proposed standard? Are there any references to relevant laws or regulations that have been omitted?
 - (b) Whether there are any laws or regulations that may, or do, prevent or impede the application of the proposed standards, or may conflict with the proposed standards?
 - (c) What, if any, are the additional significant costs to/benefits for auditors and the business community arising from compliance with the main changes to the requirements of the proposed standards? If significant costs are expected, the AUASB would like to understand:
 - (i) Where those costs are likely to occur;
 - (ii) The estimated extent of costs, in percentage terms (relative to audit fee); and
 - (iii) Whether expected costs outweigh the benefits to the users of audit services?
 - (d) What, if any, implementation guidance auditors, preparers and other stakeholders would like the AUASB to issue in conjunction with the release of ASA 540 (specific questions/examples would be helpful).
 - (e) Are there any other significant public interest matters that constituents wish to raise?

Background

IAASB

3. Developments in business environments, technology and financial instruments since extant ISA 540 became effective have given rise to new audit challenges. Further, an increasing use of estimates in preparing financial statements has increased the importance that users place on disclosures related to accounting estimates. Accordingly, the IAASB set out to develop a revised ISA 540 *Auditing Accounting Estimates and Related Disclosures*.

4. In April 2017, the IAASB issued Exposure Draft Proposed International Standard on Auditing 540 *Auditing Accounting Estimates and Related Disclosures*, with the objective of ISA 540 being for the auditor to obtain sufficient appropriate audit evidence to evaluate whether accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. There were 68 responses to the IAASB's exposure draft with general support for the objectives of the revision, but with concerns expressed regarding, inter-alia, scalability, complexity and the compartmentalisation of audit effort into three risk factors of estimation uncertainty, judgement and complexity.
5. Over the past 15 months, the IAASB have sought to address the concerns raised by respondents. On 22 June 2018, the IAASB approved ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures* and related conforming amendments to other ISAs. This is subject to approval by the Public Interest Oversight Board (PIOB) in September 2018 to confirm that due process has been followed with proper regard to the public interest.
6. As described in paragraph 14 below, the AUASB now issues ED 03/18 *Proposed Auditing Standard ASA 540 Auditing Accounting Estimates and Related Disclosures* (ED 03/18) and ED 04/18 *Proposed Auditing Standard 2018-2 Amendments to Australian Auditing Standards* (ED 04/18).
7. Given the concerns raised through the IAASB exposure process, and the consequential amendments, we outline here the major revisions from the extant ASA 540:
 - (a) *Use of the term 'reasonable' for disclosures*

ED 03/18, paragraph 11 includes the objective that related accounting disclosures should be 'reasonable' in the context of the financial reporting framework. This is a change from the extant ASA 540 paragraph 6(b), in that the extant uses the term 'adequate' when related to disclosures.
 - (b) *Scalability*

While involving a step up in work effort, especially in the area of complex estimates, ED 03/18 considers and facilitates scalability, recognizing that the standard applies to all accounting estimates. Scalability is reinforced in the following ways:

 - (i) emphasis and detailed description of the concept of a spectrum of inherent risks
 - (ii) use of wording that indicates conditionality
 - (iii) emphasis that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.
 - (c) *Professional scepticism*

Professional scepticism plays a central role in the audit of accounting estimates. ED 03/18 contains several key provisions that are designed to enhance the auditor's application of professional scepticism and consideration of the potential for management bias, including:

 - (i) enhanced risk assessment requirements
 - (ii) more prescriptive requirements with respect to obtaining audit evidence and clarification that audit evidence should be obtained in a manner that is unbiased as to whether evidence is corroborative or contradictory
 - (iii) a requirement to "stand back" and evaluate the audit evidence obtained
 - (iv) use of stronger terminology in application material such as 'question' or 'challenge'
 - (d) *Risk assessment:*

Risk assessment requirements in ED 03/18 are more specific than the extant ASA 540 to address the auditing challenges in an increasingly complex business and financial reporting environment. Enhanced requirements and application material to address risk assessment include:

- (i) a requirement, ED 03/18 paragraph 16, to make a separate assessment of inherent risk and control risk in order to drive a focus on consideration of inherent risk factors in identification and assessment of risk of material misstatement. This differs to ASA 200 paragraph A42 where the auditor may make separate or combined assessments, but aligns with ED 01/18 proposed ASA 315, which requires separate assessment of inherent risk and control risk.
- (ii) the introduction of inherent risk factors for consideration, ED 03/18 paragraph 16, of estimation uncertainty, complexity, subjectivity and other inherent risk factors.
- (iii) a requirement, ED 03/18 paragraph 17, that where a significant risk is identified, the auditor is required to obtain an understanding of the entity's controls relevant to that risk.

(e) *Responses to assessed risk of material misstatement*

- (i) ED 03/18 includes objectives-based requirements for each testing strategy based around methods, assumptions and data while considering inherent risk factors
- (ii) enhanced requirements, in ED 03/18 paragraphs 27-29, where management has not adequately addressed estimation uncertainty
- (iii) emphasises when tests of controls are required, in ED 03/18 paragraphs 19-20, including improved cross-referencing to ASA 315 and ASA 330.

(f) *Documentation:*

Expanded requirements, ED 03/18 paragraph 39, to include more specific documentation requirements for accounting estimates.

8. The conforming and consequential amendments arising from ED 03/18 are reflected in ED 04/18 *Proposed Auditing Standard ASA 2018-2 Amendments to Australian Auditing Standards* (ED 04/18). The most significant conforming and consequential amendments arising in ED 04/18 are in the following areas:

- (a) ASA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* - including identifying in the application material that ED 03/18 ASA 540 requires a separate assessment of inherent risk and control risk.
- (b) ASA 230, *Audit Documentation* - including identifying in the application material that documentation providing evidence of the auditor's exercise of professional scepticism may include documenting how the auditor evaluated evidence obtained that both corroborates and contradicts management's assertions. It also identifies that examples of documentation of significant professional judgments include the basis for the auditor's evaluation of whether an accounting estimate and related disclosures are reasonable in the context of the applicable financial reporting framework.
- (c) ASA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* - amending the application material to be clear that a retrospective review is not necessarily restricted to the prior period.
- (d) ASA 260, *Communication with Those Charged with Governance* – including identifying in the application material that those charged with governance may be interested in the auditor's views on the degree to which complexity, subjectivity or other inherent risk factors affect the selection or application of the methods,

assumptions and data used in making a significant accounting estimate, as well as the auditor's evaluation of whether management's point estimate and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework; and, when applicable, whether a significant accounting practice of the entity relating to accounting estimates is considered by the auditor not to be most appropriate to the particular circumstances of the entity.

- (e) ASA 500, *Audit Evidence*, in relation to "external information sources" - including a definition; amending the requirement in paragraph 7 to clarify that the auditor needs to consider the relevance and reliability of information to be used as audit evidence obtained from an external information source; and extensive additional application material.
 - (f) ASA 580, *Written Representations*, - amending the illustrative representation letter to align with the changes in ED 03/18 ASA 540.
 - (g) ASA 700, *Forming an Opinion and Reporting on a Financial Report* - amending the requirement in paragraph 13(c) to reflect that the auditor evaluates whether related disclosures, as well as the accounting estimates, made by management are reasonable.
 - (h) ASA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* - editorial changes to the requirement in paragraph 9 and related application material, including to reflect ED 03/18 ASA 540 references to a high "degree of" estimation uncertainty.
9. Further details can be found on the IAASB's website: <http://www.ifac.org/auditing-assurance>
- [IAASB Explanatory Memorandum and Exposure Draft ED ISA 540](#)
 - [ISA 540 Revised Auditing Accounting Estimates and Related Disclosures](#)
 - [Conforming and Consequential Amendments](#)

AUASB

10. In August 2017, the AUASB made a [written submission](#) to the IAASB in response to ED ISA 540. In formulating its response, the AUASB sought input from its constituents in three principal ways. The first was from hosting a roundtable meeting with stakeholders in three of the large Australian cities - stakeholders that represent a broad range of backgrounds including assurance providers from medium and large audit firms, audit regulators, professional accounting bodies, directors, preparers and users of financial statements. The second was through an open invitation to provide comments placed on the AUASB website. The third was by way of subsequent formal discussions by the AUASB members at recent board meetings.
11. The AUASB has closely followed the activities of the IAASB in their revisions to ED ISA 540 and consider that the majority of feedback generated by Australian constituents has been addressed in the final revised ISA 540.
12. In accordance with its mandates under section 227 of the *ASIC Act 2001* and the Financial Reporting Council's (FRC) Strategic Direction, the AUASB's policy is to adopt the IAASB's auditing standards (ISAs), unless there are compelling reasons not to do so; and to amend the ISAs only when there are compelling reasons to do so. The AUASB's principles of convergence with the ISAs and harmonisation with the New Zealand auditing standards can be found on the AUASB's website: http://www.auasb.gov.au/admin/file/content102/c3/Aug14_IAASB-NZAuASB_Principles_of_Convergence_and_Harmonisation.pdf
13. Compelling reasons fall broadly into two categories: legal and regulatory; and principles and practices considered appropriate in maintaining or improving audit quality in Australia. Compelling reasons are further guided by the AUASB's policy of harmonisation with the standards of the New Zealand Auditing and Assurance Standards Board (NZAuASB).

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14. The AUASB has decided to adopt the revised ISA, relating to auditing accounting estimates and related disclosures and the related consequential and conforming amendments, into the Australian Auditing Standards that are made under section 336 of the *Corporations Act 2001*. Prior to implementation, the AUASB is required to consult with constituents and accordingly now issues Exposure Draft ED 03/18 and Exposure Draft ED 04/18 for public exposure and comment. All comments received from constituents are considered by the AUASB prior to finalisation of the proposed revised standard.

Exposure Draft Protocols

15. Under its convergence policies, the AUASB continues to include requirements and guidance that are in addition to, or a clarification of, the equivalent ISA only when the compelling reason test have been met. Any such modifications continue to be identified in the Australian Auditing Standards by paragraph numbering commencing with an “Aus” prefix. Any such changes do not diminish the requirements of the equivalent ISA.
16. In addition to those changes that meet the compelling reason test, the AUASB makes format and terminology changes to comply with requirements relating primarily to legislative instruments. Such changes are machinery in nature and do not change the meaning of the equivalent ISA.

AUASB Modifications to the ISA

17. In line with the AUASB’s policy of convergence with the standards of the IAASB (see link at paragraph 12 above), the AUASB does not propose any modification to ISA 540 Revised and the related consequential and conforming amendments.

General

18. ED 03/18 and ED 04/18 will be open to constituents for a **70 day comment period**.
19. At the completion of the exposure period, the AUASB will consider constituents’ submissions and where the AUASB determines that compelling reason exist, amendments to the exposure drafts will be made.

Other Outreach Activities

20. In addition to the public exposure process, the AUASB intends to conduct roundtable consultative meetings and a webinar, in conjunction with the AUASB exposure draft ED 01/18 Proposed ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

Application

21. The revised standard will be applicable for financial reporting periods **beginning on or after 15 December 2019**. This application date corresponds with that of the equivalent ISA.

Early Adoption

22. Consistent with the IAASB’s policy, all Australian Auditing Standards may be early adopted unless explicitly prohibited.

Website Resources

23. The AUASB welcomes constituents’ input to the development of Australian Auditing Standards and regards both supportive and critical comments as essential to a balanced review of the proposed standards. Constituents are encouraged to access the websites of the [AUASB](#) and the [IAASB](#) to obtain further information.

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