



December 2019

AUASB Bulletin

Revised ASA 540

Auditing Accounting Estimates and Related Disclosures

Introduction

In December 2018 the AUASB issued the revised ASA 540 *Auditing Accounting Estimates and Related Disclosures* (ASA 540), dealing with the auditor's responsibilities relating to accounting estimates, including fair value estimates and related disclosures in an audit of a financial report.

Specifically, the revised standard adopts a risk-based approach to auditing accounting estimates including expanding on how ASA 315¹, ASA 330² and other auditing standards are to be applied in relation to accounting estimates. It also emphasises the importance of professional scepticism by the auditor, ensuring that appropriate attention is paid to indicators of possible management bias and their audit implications.

If you're an early adopter³, you may already be auditing under the revised ASA 540. If not, the effective date of the revised ASA 540 is just around the corner, impacting audits of financial reports for periods beginning on or after 15 December 2019. This AUASB Bulletin aims to highlight to all parties involved in the financial reporting supply chain (i.e. preparers, those charged with governance, auditors, etc.), the key changes and implications arising from this standard.

¹ ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

² ASA 330 *The Auditor's Responses to Assessed Risks*

³ ASA 540 is operative for financial reporting periods commencing on or after 15 December 2019. Early adoption of ASA 540 is permitted prior to this date.



Why did ASA 540 change?

Changes to financial reporting standards have increased the importance and visibility of accounting estimates to users of financial reports. The previous version of ASA 540 was written before recent changes in the rules governing accounting estimates (e.g. expected credit losses and revised standards dealing with insurance contracts, revenue recognition and leases). These changes, along with recurring audit inspection findings criticising the quality of audits of accounting estimates, led to the need for the International Auditing and Assurance Standards Board (IAASB) to address this challenging area to improve audit quality.

The increasingly complex business environment and change in accounting practices means that auditors need a more robust approach to identifying, assessing and responding to risks of material misstatements for accounting estimates and related disclosures. The enhancements in ASA 540 are aimed at keeping pace with evolving and complex business environments, fostering a more independent and challenging sceptical mindset of the auditor; as well as improving communications, interactions and transparency between the auditor, those charged with governance and users of financial reports.

Key Changes to ASA 540

- 1 Recognising a spectrum of inherent risk to drive scalability. The nature, timing and extent of risk assessment and responses will vary according to the risk.
- 2 Introducing the concepts of inherent risk factors including complexity, subjectivity and estimation uncertainty to encourage auditors to think more deeply about the risks inherent in accounting estimates.
- 3 Enhancing risk assessment procedures relating to obtaining and understanding of the entity and its environment, including the entity's internal control in order to understand what drives the risk of material misstatement of an accounting estimate.
- 4 Introducing objectives-based work effort requirements directed to methods, data and assumptions, to design and perform further audit procedures to respond to the assessed risks of material misstatements.
- 5 Recognising the central role that professional scepticism plays in auditing accounting estimates by introducing provisions to enhance the auditor's application of professional scepticism.
- 6 Enhancing disclosures disclosure requirements to obtain audit evidence about whether the related disclosures are 'reasonable'.

Implications for auditors, preparers and audit committees

Auditors

Auditors are required to apply the revised ASA 540 in auditing the broad range of estimates underlying financial reports.

Among the areas of particular focus in the revised ASA 540 is the requirement for the auditor to show adequate professional scepticism and to be alert for management bias. There is also a strong emphasis on the auditor documenting the management estimation process, including understanding:

- Management's assessment of material misstatement risks; and
- Management's methods, assumptions and data used in determining the estimate and related disclosures.

The level of subjectivity and complexity underlying these estimates, and the degree of estimation uncertainty will impact the required response by auditors.

Preparers

Preparers of financial reports may expect greater scrutiny and questioning of their accounting estimates from their auditors; particularly where preparers are incorporating the recent changes in accounting for expected credit losses and revised accounting standards dealing with insurance contracts, revenue recognition and leases.

Although ASA 540 applies to all estimates, the implications for preparers are likely to vary significantly depending on the industry and the auditors' assessment of the risk that incorrect estimation may cause a material misstatement. Where the auditor determines the risk of material misstatement to be higher, the auditor's work effort will increase, which in turn will likely impact the extent of evidence the auditor will require to support the estimate and its disclosures.

Preparers will need to brief audit committees on significant accounting estimates, particularly those that may have engaged more auditor work effort under the new standard.

Audit Committees

Audit committees can expect to be briefed as to areas of judgment and estimation, both of which can take up more senior auditors' time and effort as these are often the more complex areas of the audit that need to be reported appropriately and robustly challenged.

Additionally, if the auditor's consideration of an accounting estimate is a matter that required significant auditor attention, this may lead to the reporting of key audit matters for many listed entities where the auditor's report to the shareholders may explain how the auditor has addressed significant estimates.

Feedback welcome

Feedback and queries should be directed to enquiries@auasb.gov.au or by telephone +61 3 8080 7445.

What are the standards setting boards doing to assist users of ASA 540

AUASB

The AUASB Technical Group presented a webinar for CPA Australia on Revised ASA 540. The [webinar](#), which was aimed at small and medium practitioners, outlined the key changes to ASA 540 and illustrated some practical applications of the standard.

The AUASB technical group presented at the CAANZ 2019 Audit Conferences on the Revised ASA 540 and considered 'whether the revisions represented a quantum shift or not'.

IAASB

The IAASB has an ISA 540 Implementation Working Group that intends to provide implementation support to help auditors navigate and apply the revised standard.

To date, the IAASB has issued the following implementation support materials:

- [Audit Client Briefing](#) to make those responsible for financial statement preparation aware of matters to consider in preparation for and responding to the revisions of ISA 540.
- [Flowcharts and a diagram](#) to support the understanding, and effective implementation of the standard.
- [Video panel discussions](#) focussing on providing an overview of the standard, how firms are planning its implementation and sharing practical examples, tips and suggested good practices.

Concluding messages

We can expect that estimates will remain topical in the financial reporting profession for some time due to the nature of the subject matter and complexity of the accounting requirements that apply to them.

The revisions to ASA 540 will ensure continuous improvement in audit quality and transparency. However, the revised standard is more complex and detailed than the extant standard it is replacing.

This makes the revised standard more challenging for auditors to apply, and it is expected that there will be an uplift in auditors' time and effort in this complex and judgemental area of the audit.

It is essential that all those in the financial reporting supply chain are informed and prepared to address these new requirements.



Australian Government

Auditing and Assurance Standards Board