CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Implementation Tool for Auditors

CANADIAN AUDITING STANDARDS (CAS)

SEPTEMBER 2021

Auditing Accounting Estimates and Related Disclosures Under CAS 540: What, Why and How?

STANDARD DISCUSSED

CAS 540, *Auditing Accounting Estimates and Related Disclosures*

For entities of all types and sizes, management often has to make accounting estimates when monetary amounts in financial statements cannot be directly observed. Accounting estimates all have some degree of estimation uncertainty due to inherent limitations in management's knowledge or due to data that give rise to inherent subjectivity and variation in the measurement outcomes. Along with being subjective, accounting estimates may also be complex.

These characteristics of accounting estimates have important implications for the financial statement audit, because the effects of measurement uncertainty, complexity, subjectivity or other inherent risk factors on the measurement of these monetary amounts affects their susceptibility to misstatement.

CAS 540, *Auditing Accounting Estimates and Related Disclosures*, deals with the auditor's responsibilities relating to accounting estimates and related disclosures. The auditor's objective is to obtain sufficient, appropriate audit evidence about whether accounting estimates and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework (AFRF). This CAS is effective for audits of financial statements for periods beginning on or after December 15, 2019.

Important Considerations in Using This Tool

This *Implementation Tool for Auditors* (*Tool*):

- Assists in implementing CAS 540 including significant changes made from the previous version of that CAS. It applies to the audit of the financial statements of any type of entity, regardless of its nature, size or complexity, or of whether the entity's accounting estimates are simple or complex or whether the risk of material misstatement is significant or not.
- Provides an overview of steps and related matters to consider in auditing accounting estimates and related disclosures. The focus is on matters most likely to need clarification. It contains "What," "Why" and "How" suggestions. These suggestions are not all-encompassing; more or different considerations may apply depending on the circumstances of the engagement. The choice of specific procedures the practitioner decides to perform to meet the requirements of CAS 540 and other relevant CAS is a matter of professional judgment.
- Does not replace the need to read the entire CAS 540, including the application and other explanatory material.
- Is intended to be used in conjunction with other non-authoritative material, for example:
  - IFAC's "**Implementation Support for ISA 540 (Revised) Accounting Estimates**", which provides links to several materials including videos covering an overview of ISA 540, scalability, risk assessment and inherent risk factors and professional skepticism.
  - **ISA 540 (Revised) presentation**, where the International Auditing and Assurance Standards Board (IAASB) Board member and chair of the ISA 540 (Revised) Implementation Working Group explains the public interest issues addressed in the revised standard, as well as the main changes and planned activities of the working group.
  - **ISA 540 (Revised) slide decks**, two slide decks that assist IAASB members, national standard setters, auditors, regulators and others to promote awareness of **ISA 540 (Revised)** within their respective jurisdictions. The summary slide deck provides a high-level overview of ISA 540 (Revised), while the overview slide deck provides a more detailed overview of the changes.
  - IAASB's ***At a Glance***, a summary providing an overview of the changes to ISA 540 (Revised).
  - **ISA 540 (Revised) illustrative examples for auditing simple and complex accounting estimates** and **ISA 540 (Revised) illustrative examples for auditing expected credit loss accounting estimates**, where examples are designed to illustrate how an auditor could address certain requirements of ISA 540 (Revised) for accounting estimates with varying characteristics and degrees of complexity.
  - CPA Canada's ***Audit Client Briefing***, which is designed to help your clients better understand the auditing process under revised CAS 540.

The primary objective of this *Tool* is to assist in obtaining an understanding of the "What", "Why" and "How" of the requirements in CAS 540 and to complement and supplement information in other non-authoritative publications addressing matters in this CAS.

Form and Content of this *Tool*	
Appendix 1 – IAASB Flowchart: ISA 540 (Revised) Requirements*	• provides an overview of the flow of the requirements in ISA 540 • step numbers have been added to the Flowchart which link to Appendix 2
Appendix 2 – A table of 10 steps	• summarizes key aspects of what is required by CAS 540 and other considerations related to "What" (requirements), "Why" (reason) and "How" (practical considerations) • highlights key changes from the previous version of CAS 540 by way of callouts boxes; these key changes are identified in IAASB's *At a Glance* publication regarding ISA 540 (Revised)
Appendix 3 – IAASB Flowchart: Three Testing Approaches*	• provides an overview of the three possible approaches to performing further audit procedures on accounting estimates
Appendix 4 – IAASB Diagram: Linkages between ISA 540 (Revised) and Other ISAs*	• summarizes key links between ISA 540 (Revised) and other ISAs; some requirements and other guidance in ISA 540 (Revised) refer to or expand on how ISA 315 (Revised), ISA 330, ISA 450 and ISA 500 and other relevant ISAs should be applied in relation to accounting estimates and related disclosures[1]
Appendix 5 – Scalability	• provides guidance on how CAS 540 is scalable Although CAS 540 applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. As a result, the nature, timing and extent of the risk assessment and further audit procedures (**tests of controls** and **substantive procedures**) will vary in relation to the: — degree of inherent risk factors — auditor's assessment of the related risks of material misstatement

* The flowcharts and diagram were developed by the IAASB. Since there are no Canadian amendments, revised CAS 540 mirrors ISA 540 (Revised).

Note: This Tool has been updated to reflect changes as a result of revised CAS 315, *Identifying and Assessing the Risk of Material Misstatement*. Revised CAS 315 is effective for audits of financial statements for periods beginning on or after December 15, 2021.

Some Overall Matters to Consider in Implementing CAS 540

Professional skepticism

Professional skepticism needs to be exercised during all aspects of the audit including when auditing accounting estimates. This need applies regardless of the nature, size or complexity of the audited financial statements. This is especially important when the assessment of inherent risk is higher because of a higher degree of estimation uncertainty, complexity, subjectivity or other inherent risk

1 CAS 315, *Identifying and Assessing the Risks of Material Misstatement;* CAS 330, *The Auditor's Responses to Assessed Risks;* CAS 450, *Evaluation of Misstatements Identified During the Audit;* CAS 500, *Audit Evidence.*

factors. Also, the exercise of professional skepticism may assist in identifying circumstances where there is greater susceptibility to misstatement due to management bias or fraud, and it may also assist in determining the nature, timing and extent of procedures to respond to these circumstances.

There may be no single way in which the auditor's exercise of professional skepticism is documented. Nevertheless, the audit documentation may provide evidence of the exercise of professional skepticism. For example:

- **How** the auditor has applied their understanding of the entity and its environment (paragraph 13 of CAS 540) in developing their own expectations about the accounting estimates and related disclosures that should be included in the entity's financial statements, and **how** those expectations compare with the entity's financial statements prepared by management
- **How** the auditor has designed and performed audit procedures to obtain sufficient appropriate audit evidence in a manner that is not biased toward obtaining audit evidence that may be corroborative or toward excluding audit evidence that may be contradictory
- **How** the auditor has considered all relevant audit evidence, whether corroborative or contradictory
- **How** the auditor has evaluated audit evidence obtained when such audit evidence both corroborates **and** contradicts management's assertions (this would include the professional judgments made in forming the conclusion as to the sufficiency and appropriateness of the audit evidence obtained)
- **How** the auditor has addressed indicators of possible management bias

Consultation and Feedback

In the interest of continuous improvement and our commitment to the development of quality non-authoritative guidance, we would welcome any comments or questions regarding this non-authoritative guidance. Comments on this *Implementation Tool for Auditors* or suggestions for future publications should be sent to:

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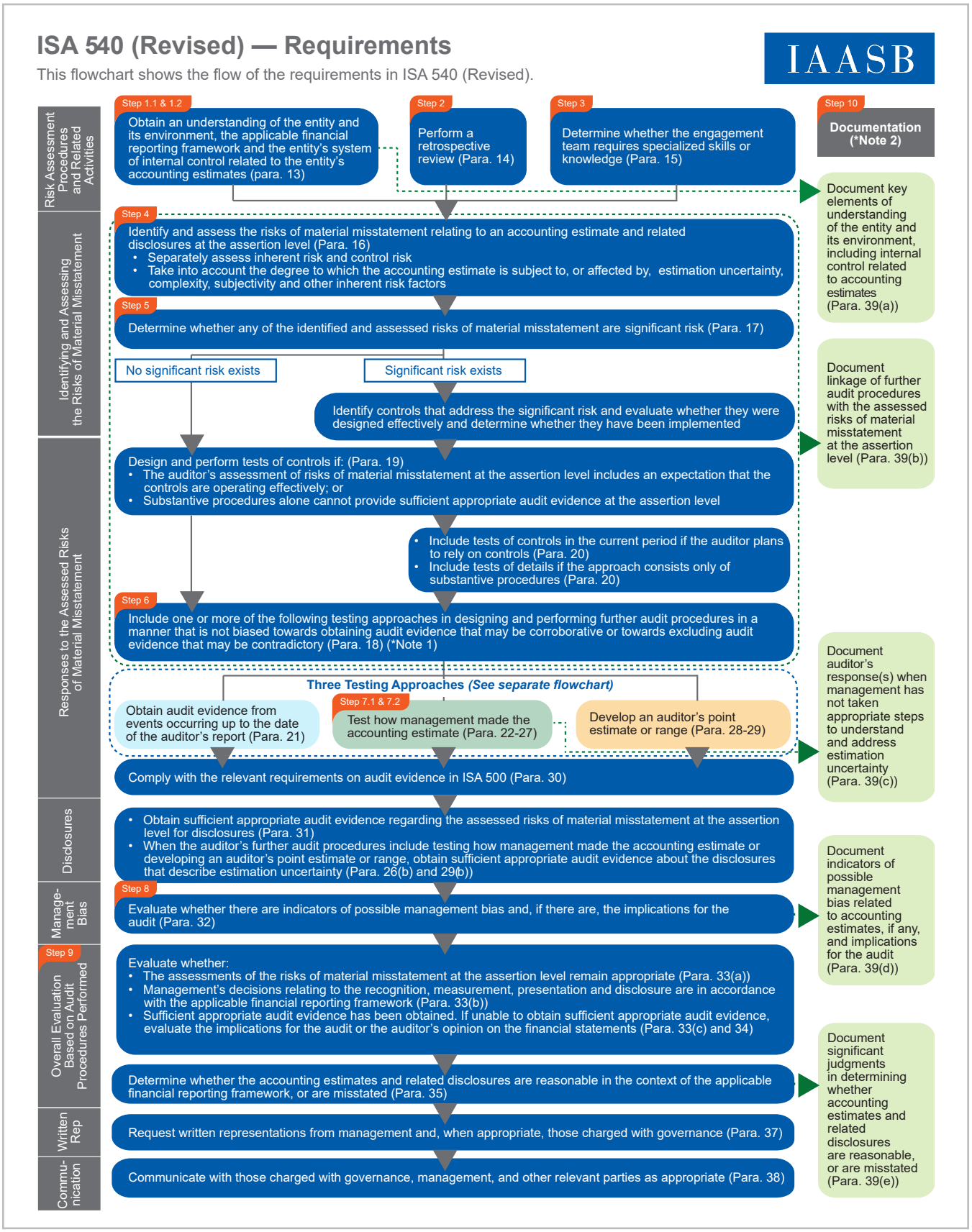
Appendix 1: ISA 540 (Revised) Requirements*



* **Notes**

1. Scalability
   - The nature, timing and extent of the risk assessment and further audit procedures will vary in relation to the estimation uncertainty and the assessment of the related risks of material misstatement. (Para. 3)
     - The auditor's procedures to obtain the understanding of the entity and its environment shall be performed to the extent necessary to provide an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. (Para. 13)
     - The auditor's further audit procedures need to be responsive to the reasons for the assessment of the risks of material misstatement at the assertion level and that the auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. (Para. 18)
   - Guidance that demonstrates how the standard is scalable can be found in paragraphs A20–A22, A63, A67 and A84. (Para. A7)
2. Documentation
   - Paragraph 39 of ISA 540 (Revised) outlines the specific documentation requirements with respect to auditing accounting estimates and related disclosures. Refer to ISA 230, Audit Documentation, with respect to the auditor's responsibility to prepare audit documentation for an audit of financial statements, and its Appendix, which lists other ISAs that contain specific documentation requirements and guidance.
3. Step numbers have been added to the Flowchart which link to Appendix 2.

Appendix 2: 10 Steps

STEP 1.1 Obtain an understanding of the entity and its environment and the applicable financial reporting framework related to its accounting estimates and related disclosures. [CAS 540.13 (a) to (d)]

Enhanced, more detailed requirements and application material

When obtaining an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control, as required by CAS 315, the auditor shall obtain an understanding of the following matters related to the entity's accounting estimates. The auditor's procedures to obtain the understanding shall be performed to the extent necessary to obtain audit evidence that provides an appropriate basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels.

What

Obtaining an Understanding of The Entity and Its Environment and the Applicable Financial Reporting Framework (AFRF)

a. The entity's transactions and other events or conditions that may give rise to the need for, or changes in, accounting estimates to be recognized or disclosed in the financial statements.

b. The requirements of the applicable financial reporting framework related to accounting estimates (including the recognition criteria, measurement bases and the related presentation and disclosure requirements); and how they apply in the context of the nature and circumstances of the entity and its environment, including how the inherent risk factors affect susceptibility to misstatement of assertions.

c. Regulatory factors relevant to the entity's accounting estimates including, when applicable, regulatory frameworks related to prudential supervision.

d. The nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements, based on the auditor's understanding of the matters in 13(a) – (c) above.

Why

- To help provide an appropriate basis for identifying and assessing any risks that an accounting estimate may be materially misstated. For example, it may identify:
  - — transactions or other events or conditions affected by inherent risk factors that increase the risk of material misstatement
  - — risk factors that have changed significantly since the previous audit
  - — changes in requirements of the AFRF or regulations

  Obtaining an understanding of the requirements of the AFRF provides a basis for discussing with management how they applied those requirements of the AFRF relevant to the accounting estimates.

STEP 1.1 Obtain an understanding of the entity and its environment and the applicable financial reporting framework related to its accounting estimates and related disclosures. [CAS 540.13 (a) to (d)]

How

- Consider whether the AFRF:
  - prescribes certain criteria for the recognition, or methods for the measurement of accounting estimates
  - specifies certain criteria that permit or require measurement at a fair value, for example, by referring to management's intentions to carry out certain courses of action with respect to an asset or liability
  - specifies required or suggested disclosures, including disclosures concerning judgments, assumptions or other sources of estimation uncertainty relating to accounting estimates
- Make inquiries of those who prepare and review the accounting estimates and of those in other functions who are likely to be aware of the types of transactions, conditions and events that result in a need to make new or amended accounting estimates.
- Make inquiries about changes in the entity's operations, including changes in its business environment and technology. Support these inquiries, when appropriate, through inspection, observation and reading of relevant documents. For example, you may review new major contracts to identify whether they contain terms likely to affect accounting estimates.
- Perform analytical procedures to help identify relevant transactions and other events or conditions, including unusual or unexpected relationships.

STEP 1.2 Obtain an understanding of the entity's system of internal control related to its accounting estimates. [CAS 540.13(e) to (j)]

What

Obtaining an Understanding of The Entity's System of Internal Control

Enhanced, more detailed requirements and application material

e. The nature and extent of oversight and governance that the entity has in place over management's financial reporting process relevant to accounting estimates.

f. How management identifies the need for, and applies, specialized skills or knowledge related to accounting estimates, including with respect to the use of a management's expert.

g. How the entity's risk assessment process identifies and addresses risks relating to accounting estimates.

h. The entity's information system as it relates to accounting estimates, including:

   i. How information relating to accounting estimates and related disclosures for significant classes of transactions, account balances or disclosures flows through the entity's information system; and

   ii. For such accounting estimates and related disclosures, how management:

      a. Identifies the relevant methods, assumptions or sources of data, and the need for changes in them, that are appropriate in the context of the applicable financial reporting framework, including how management:

         i. Selects or designs, and applies, the methods used, including the use of models;

         ii. Selects the assumptions to be used, including consideration of alternatives, and identifies significant assumptions; and

         iii. Selects the data to be used;

      b. Understands the degree of estimation uncertainty, including through considering the range of possible measurement outcomes; and

      c. Addresses the estimation uncertainty, including selecting a point estimate and related disclosures for inclusion in the financial statements.

i. Identified controls in the control activities component over management's process for making accounting estimates as described in paragraph 13(h)(ii).

j. How management reviews the outcome(s) of previous accounting estimates and responds to the results of that review.

Why

- To assist you in identifying and assessing risks of material misstatement and in designing the nature, timing and extent of your further audit procedures.

STEP 1.2 Obtain an understanding of the entity's system of internal control related to its accounting estimates. [CAS 540.13(e) to (j)]

How

When applying the requirements of CAS 315 related to accounting estimates, **obtain an understanding** of the following:

Oversight and governance of the financial reporting process

- how the nature and extent of oversight and governance that the entity has in place over management's processes for making accounting estimates, may assist you in evaluating whether:
  - management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior
  - the control environment provides an appropriate foundation for the other components of the system of internal control considering the nature and size of the entity
  - control deficiencies identified in the control environment undermine the other components of the system of internal control.
- identifying when specialized skills or knowledge are required and, if so, applying them

The entity's risk assessment process

- how management:
  - identifies financial or other incentives that may motivate bias or fraud by those making accounting estimates
  - monitors and responds to the need for changes in methods, significant assumptions or the data used in making accounting estimates, taking into account, for example, changes in the AFRF, or the nature, availability and reliability of data

The entity's information system relating to accounting estimates

- how the information system (for the significant classes of transactions, events and conditions relating to accounting estimates [see paragraph 25(a) of CAS 315]):
  - captures and processes information for accounting estimates that arise from routine and recurring transactions as well as those that arise from non-recurring or unusual transactions
  - addresses the completeness of accounting estimates and related disclosures, in particular for accounting estimates related to liabilities

The entity's process to monitor the system of internal control

- how management supervises and reviews procedures designed to detect and correct any deficiencies in the design or operating effectiveness of controls

Identified controls in the control activities component over management's process for making accounting estimates

- how management determines the appropriateness of the data used, whether from internal or external sources
- whether appropriate levels of management (and perhaps those charged with governance) review and approve the assumptions, data and methods used
- what segregation of duties is in place between those responsible for making the accounting estimates and those committing the entity to the related transactions
- when IT tools are used in making the accounting estimate, what general IT and information processing controls are in place related to, for example, the complete and accurate extraction and flow of data through the entity's information system and the appropriateness of any modification to the data maintaining the integrity and security of the data

STEP 1.2 Obtain an understanding of the entity's system of internal control related to its accounting estimates. [CAS 540.13(e) to (j)]

You can achieve this understanding of the above components of the entity's system of internal control by:

- inquiring of relevant personnel about the procedures used to initiate, record, process and report transactions or about the entity's financial reporting process
- inspecting policy or process manuals or other documentation of the entity's IT applications or other aspects of the IT environment
- observing the performance of the policies or procedures by entity's personnel
- selecting transactions and tracing them through the applicable process in the IT applications or other aspects of the IT environment (i.e., performing a walk-through)

You can obtain audit evidence about the design and implementation of identified controls in the control activities component over management's process for making accounting estimates (including those related to significant risks) by:

- inquiring of entity personnel
- observing the application of specific controls
- inspecting documents and reports

However, inquiry alone is not sufficient for such purposes.

STEP 2. Perform a retrospective review. (CAS 540.14)

What

- The auditor shall review the outcome of previous accounting estimates, or, where applicable, their subsequent re-estimation to 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 judgments about previous period accounting estimates that were appropriate based on the information available at the time they were made.

Why

- Information about how effective management's previous estimation process was provides audit evidence about how effective management's current process is likely to be.
- To determine whether changes in the previous year's accounting estimates:
  - Represent a misstatement.
  - Need to be disclosed in the current period's financial statements.
- May obtain:
  - Audit evidence of matters such as the reasons for changes that may be required to be disclosed in the financial statements
  - Information about the complexity or 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

STEP 2. Perform a retrospective review. (CAS 540.14)

How

- The review may cover accounting estimates made in one or more previous fiscal years, half-years or quarters. The period covered may depend on when the outcome of an accounting estimate is resolved.
- If there is evidence that management failed to consider relevant and reliable information that it had, or reasonably could have obtained, related to previous accounting estimates, a difference between the outcome and management's accounting estimate may be a misstatement.
- Consider whether there is any indication that one or more previous accounting estimates were biased. As a practical matter, the review of management judgments and assumptions for biases that could represent a risk of material misstatement due to fraud in accordance with CAS 240.33(b)(ii) may be carried out in conjunction with the review required by CAS 540.[2]
- Analytical procedures may be applied to perform the review. These may be useful when accounting estimates arise from the recording of routine and recurring transactions. For example, trends may be identified indicating, on a preliminary basis, whether this year's accounting estimates appear reasonable. On the other hand, based on the assessment in a previous year, one or more inherent risks of material misstatement may be assessed as higher. In that case, a more detailed retrospective review may be required, for example – when practicable – a focus on how the data and significant assumptions used affected the previous accounting estimates.
- Review the dates on relevant documentation (for example, contracts and meeting minutes) to determine when management had relevant reliable information to make previous accounting estimates or could reasonably have obtained it.

STEP 3. Determine whether the engagement team requires specialized skill or knowledge. (CAS 540.15)

What

With respect to accounting estimates, the auditor shall determine whether the engagement team requires specialized skills or knowledge to perform the risk assessment procedures, to identify and assess the risks of material misstatement, to design and perform audit procedures to respond to those risks, or to evaluate the audit evidence obtained.

Why

- Quality control standards require that the engagement partner be satisfied that the engagement team and any auditor's experts collectively have the appropriate competence and capabilities to perform the audit engagement and enable an auditor's report that is appropriate in the circumstances.
- In some cases, this could mean that the firm may be able to audit accounting estimates only when:
  - — the engagement team includes:
    - one or more members with specialized skills or knowledge of certain aspects of the accounting estimate, the business, or industry
    - auditor's internal experts who possess expertise in fields other than accounting or auditing

  or

  - — the firm uses the work of auditor's external experts

2 CAS 240, *The Auditor's Responsibilities Related to Fraud in an Audit of Financial Statements*.

STEP 3. Determine whether the engagement team requires specialized skill or knowledge. (CAS 540.15)

How

The nature, timing and extent of the involvement of individuals with specialized skills may vary throughout the audit, depending on the particular circumstances encountered. Note that many accounting estimates do not require the application of specialized skills or knowledge. For example, specialized skills or knowledge may not be needed for a simple inventory obsolescence calculation.

Consider the following:

- whether your engagement team already has an understanding of, and practical experience with, auditing accounting estimates of a similar nature and complexity
- whether management has (or, based on your assessment, should have) engaged one or more experts to help:
  - develop and apply concepts and techniques (including methods, models and assumptions) to meet the requirements of the AFRF
  - interpret certain types of data that are inherently difficult to understand because they require an understanding of technically complex business or legal concepts
  - address potential difficulties in obtaining data from various sources or in maintaining its integrity in applying the method, or in understanding the relevance and reliability of that data

  Management's use of experts may indicate that the engagement team also needs to use the work of an auditor's expert.
- whether the accounting estimate relates to unusual or infrequent conditions, transactions or events
- the nature of the accounting estimate for the entity's type of business or industry (for example, accounting estimates related to mineral deposits, agricultural assets, complex financial instruments, credit losses for financial institutions and insurance contract liabilities)
- the degree of estimation uncertainty
- the complexity of:
  - methods or models used, including for example when management has developed a model internally and 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
  - requirements of the AFRF; for example, for some accounting estimates, the AFRF may require the use of multiple sources of historical and forward-looking data or assumptions, with multiple interrelationships between them
  - the entity's use of IT in making accounting estimates, and the extent of such use
- the need for and degree of judgment in selecting data and making assumptions and decisions about matters not specified by the AFRF

STEP 4. Identify and assess the risks of material misstatement. (CAS 540.16 and 540.19)

What

In identifying and assessing the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, including separately assessing inherent and control risk at the assertion level, as required by CAS 315, the auditor shall take the following into account in identifying the risks of material misstatement and in assessing inherent risk:

a. The degree to which the accounting estimate is subject to estimation uncertainty; and

b. The degree to which the following are affected by complexity, subjectivity, or other inherent risk factors:

   i. The selection and application of the method, assumptions and data in making the accounting estimate; or

   ii. The selection of management's point estimate and related disclosures for inclusion in the financial statements.

As required by CAS 330, the auditor shall design and perform tests to obtain sufficient appropriate audit evidence as to the operating effectiveness of controls, if:

a. The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or

b. Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In relation to accounting estimates, the auditor's tests of such controls shall be responsive to the reasons for the assessment given to the risks of material misstatement. In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control.

- New requirement to separately assess inherent risks and control risks at the assertion level
- More emphasis on the importance of auditor's decisions on whether to rely on the operating effectiveness of controls

Specific recognition of the concept of the spectrum of inherent risk

Focus on and clarification of the concept of inherent risk factors (estimation uncertainty, complexity, subjectivity and others)

Why

- To help provide an appropriate basis for designing and performing your substantive procedures to respond to the risks of material misstatement, including significant risks, at the assertion level for accounting estimates.
- To assess the likelihood and magnitude of misstatement. The level of inherent risk varies on a scale (the "spectrum of inherent risk"). The higher your assessed inherent risk is on this spectrum, the more persuasive (relevant and reliable) the audit evidence provided by your substantive procedures needs to be.
- Identifying and assessing risks of material misstatement at the assertion level also applies to those accounting estimates included in the notes to the financial statements.

STEP 4. Identify and assess the risks of material misstatement. (CAS 540.16 and 540.19)

How

- To assess inherent risk, use the results of your procedures from Steps 1 – 3 and make additional inquiries and observations and perform additional reviews of documents and other procedures as needed.
- To assess control risk:
  - Use your preferred audit techniques or methodologies.
  - Take into account whether the audit contemplates planned reliance on the operating effectiveness of controls.

  If tests of controls are not performed, the assessment of the risk of material misstatement at the assertion level cannot be reduced for the effective operation of controls with respect to the particular assertion.
- The following examples may increase or decrease risk. Consider whether:
  - There are constraints on obtaining reliable data from external sources or on the amount of knowledge that management can obtain about the subject matter of an accounting estimate.
  - Data from past events is useful in predicting future outcomes.
  - Management's methods require the use of unobservable inputs.
  - A lack of prescriptive guidance in the AFRF results in a need for management to use considerable judgment in selecting methods, assumptions and data sources. This may increase the degree of subjectivity in making an accounting estimate and the likelihood of intentional or unintentional management bias or other fraud risk factors insofar as they affect inherent risk.
  - Those making and reviewing the accounting estimates have obtained and applied appropriate levels of specialized skills and knowledge when warranted.
  - Events occurring after the date of the financial statements may provide additional information relevant to your risk assessments. This information may result in a need to revise your initial assessments.

STEP 5. Identify and assess any significant risks and identify controls that address the significant risk and evaluate whether they were designed effectively and determine whether they have been implemented. (CAS 540.17 and 540.20)

What

The auditor shall determine whether any of the risks of material misstatement identified and assessed in accordance with paragraph 16 of CAS 540 are, in the auditor's judgment, a significant risk. If the auditor has determined that a significant risk exists, the auditor shall identify controls that address that risk and evaluate whether such controls have been designed effectively, and determine whether they have been implemented.

For a significant risk relating to an accounting estimate, the auditor's further audit procedures shall include tests of controls in the current period if the auditor plans to rely on those controls. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

STEP 5. Identify and assess any significant risks and identify controls that address the significant risk and evaluate whether they were designed effectively and determine whether they have been implemented. (CAS 540.17 and 540.20)

Why

- You need to obtain more persuasive audit evidence to respond to a significant risk, including a risk that fraudulent financial reporting may occur through intentional misstatement of accounting estimates.
- These requirements are already required by CAS 315 (CAS 315.26(a)(i) and CAS 315.32) and CAS 330 (CAS 330.15 and CAS 330.21). They are repeated in CAS 540 as an important reminder to apply them to your audit of accounting estimates.

How

- The procedures you perform in Step 4 to identify and assess inherent risks assist you in identifying and assessing significant risks.
- Take into account the relative effects of the inherent risk factors that result in risks being at the higher end of the spectrum of inherent risk.
- Assess the susceptibility of the accounting estimate and related disclosures to material misstatement due to management fraud, as required by CAS 240.
- Consider whether an accounting estimate and related disclosures are affected by:
  - recent significant economic, accounting or other developments that require specific attention
  - significant transactions with related parties
  - significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual
- Determine whether it is practicable to obtain sufficient appropriate audit evidence for an accounting estimate by performing only substantive procedures or whether the operating effectiveness of controls also needs to be tested. This may be the case, for example, when an estimation process is highly automated and complex.

STEP 6. Determine the approach you will use in performing substantive procedures (CAS 540.18)

What

As required by CAS 330, the auditor's further audit procedures shall be responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks. The auditor's further audit procedures shall include one or more of the following approaches:

More emphasis and detail on planning and performing audit procedures directed to methods, data and assumptions that appropriately respond to your assessed risks of material misstatement

a. Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21);

b. Testing how management made the accounting estimate (see paragraphs 22 – 27); or

c. Developing an auditor's point estimate or range (see paragraphs 28 – 29).

The auditor's further audit procedures shall take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. The auditor shall 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.

STEP 6. Determine the approach you will use in performing substantive procedures (CAS 540.18)

Why

- The approach you choose needs to appropriately respond to your assessed risks of material misstatement and thereby enable you to obtain sufficient appropriate audit evidence about whether the accounting estimate and related disclosures are reasonable in the context of the AFRF.
- Obtaining audit evidence in an unbiased manner is an important aspect of exercising professional skepticism. Avoiding bias may involve obtaining evidence from multiple sources within and outside the entity. However, you are not required to perform an exhaustive search to identify all possible sources of audit evidence

How

- You may use the three approaches individually, or in combination, in auditing one or more of the data, assumptions or methods used by management.
- Consider using Approach A when the outcome of events relevant to an accounting estimate becomes known before the date of your auditor's report and therefore estimation uncertainty is minimal and not likely to require disclosure.
- Consider using Approach B when, for example:
  - Your experience in previous audits indicates that management's estimation process is likely to be appropriate.
  - The accounting estimate is based on a large population of items of a similar nature that individually are not significant.
  - The AFRF specifies how management is expected to make the accounting estimate.
  - The accounting estimate is derived from the routine processing of data.
- Consider using Approach C when the other approaches on their own, or in combination, are unlikely to provide sufficient appropriate audit evidence and there are appropriate alternative assumptions or sources of relevant data that you can use. Developing a point estimate, rather than a range, may be more effective when you expect less variability in the reasonably possible outcomes and therefore your point estimate can be developed with a higher degree of precision.

STEP 7.1 Test how management made the estimate. (*Note: This step describes Approach B to performing further audit procedures in response to assessed risks with no reliance on the effective operation of controls.*) (CAS 540.22 – .25 and .31)[3]

What

When testing how management made the accounting estimate, the auditor's further audit procedures shall include procedures, designed and performed in accordance with paragraphs 23 – 26, to obtain sufficient appropriate audit evidence regarding the risks of material misstatement relating to:

a. The selection and application of the methods, significant assumptions and the data used by management in making the accounting estimate; and

b. How management selected the point estimate and developed related disclosures about estimation uncertainty.

The further audit procedures shall address whether:

Methods, significant assumptions and data

- management's methods, significant assumptions and data are appropriate in the context of the AFRF and the circumstances of the entity, and that changes, if any, from prior periods are appropriate; and
- judgments made in selecting the method, significant assumptions and data give rise to indicators of possible management bias.

Methods

- the integrity of the significant assumptions and the data has been maintained in applying the method;
- the calculations are applied in accordance with the method and are mathematically accurate; and
- for complex models, judgments have been applied consistently and whether, when applicable:
  - The design of the model meets the measurement objective of the AFRF, is appropriate in the circumstances, and if applicable, changes from the prior period's model are appropriate in the circumstances.
  - Adjustments to the output of the model are consistent with the measurement objective of the AFRF and are appropriate in the circumstances.

Significant assumptions

- based on the knowledge obtained in the audit, management's significant assumptions are consistent with each other and with those used in other accounting estimates, or with related assumptions used in other areas of the entity's business activities.
- when applicable, management has the intent to carry out specific courses of action and has the ability to do so.

Data

- the data is relevant and reliable in the circumstances; and
- that management has appropriately understood or interpreted the data, including with respect to contractual terms.

Disclosures

Design and perform further audit procedures to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement at the assertion level for disclosures related to an accounting estimate, other than those about estimation uncertainty (see Step 7.2).

3 For information on the use of approaches A and C, or a combination thereof, see (IAASB ISA 540 FAQ coming soon).

STEP 7.1 Test how management made the estimate. (*Note: This step describes Approach B to performing further audit procedures in response to assessed risks with no reliance on the effective operation of controls.*) (CAS 540.22 – .25 and .31)[3]

Why

- To appropriately respond to assessed risks and thereby enable you to obtain sufficient appropriate audit evidence about whether the accounting estimate and related disclosures resulting from management's selection and application of its methods, significant assumptions and data are reasonable in the context of the AFRF.
- Arbitrary changes in management's methods, significant assumptions or data sources may indicate possible management bias and a risk of material misstatement.

How

Methods, significant assumptions, data and disclosures

- Inquire of management about its reasons for choosing particular approaches to making estimates and developing related disclosures.
- Review management's documentation of its processes.
- Examine relevant contracts.

Methods or models

- When management has determined that different methods result in a range of significantly different accounting estimates, consider how they have investigated the reasons for those differences.
- For complex models, consider how management validated their model before using it and made periodic reviews to ensure it is still suitable to be used as intended.

Significant assumptions

- Significant assumptions are those that would materially affect the measurement of the accounting estimate if there was a reasonable variation in the assumption.
- A sensitivity analysis may be useful in demonstrating the degree to which the measurement varies based on one or more assumptions used in making the accounting estimate.
- A sensitivity analysis may also help the auditor identify what assumptions are the most sensitive so that they can develop an appropriate audit response – i.e., the more significant the sensitivity, the more persuasive the supporting audit evidence is required to be.
- Review management's history of carrying out its stated intentions.
- Review documentation such as written plans, formally approved budgets, authorizations or minutes.
- Evaluate the implications of its existing commitments and legal, regulatory or contractual restrictions that could affect the feasibility of management's actions on which assumptions are based.

Data

- Check the accuracy and completeness of data by selecting a sample of data (or use an automated procedure to select 100% of relevant data).
- This may include considering that all intended changes to data, and no unintended changes, were made during activities such as input, storage, retrieval, transmission or processing.

Disclosures

Disclosures may relate, for example, to management's rationale for selecting particular methods, assumptions and data and the effects of any changes from the prior period.

STEP 7.2 Evaluate management's selection of its point estimate and related disclosures about estimation uncertainty. This describes Approach B with no reliance on the effective operation of controls. (CAS 540.26 – .27)

What

In applying the requirements of paragraph 22, the auditor's further audit procedures shall address whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to:

a. Understand estimation uncertainty; and

b. Address estimation uncertainty by selecting an appropriate point estimate and by developing related disclosures about estimation uncertainty.

When, in the auditor's judgment based on the audit evidence obtained, management has not taken appropriate steps to understand or address estimation uncertainty, the auditor shall:

a. Request management to perform additional procedures to understand estimation uncertainty or to address it by reconsidering the selection of management's point estimate or considering providing additional disclosures relating to the estimation uncertainty, and evaluate management's response(s) in accordance with paragraph 26;

b. If the auditor determines that management's response to the auditor's request does not sufficiently address estimation uncertainty, to the extent practicable, develop an auditor's point estimate or range in accordance with paragraphs 28 – 29; and

c. Evaluate whether a deficiency in internal control exists and, if so, communicate in accordance with CAS 265.

Why

- To appropriately respond to assessed risks and thereby enable you to obtain sufficient appropriate audit evidence about whether the accounting estimate resulting from management's selection of its point estimate and development of related disclosures about estimation uncertainty are reasonable in the context of the AFRF.

How

- In addition to the "What" and "How" procedures and considerations in Step 7.1, consider whether:
  - Attributes of an asset or liability used in estimating its fair value (valuation attributes) were appropriate and complete.
  - Management's point estimate is appropriately chosen from the reasonably possible measurement outcomes.
  - When applicable, management has followed requirements in the AFRF that prescribe how to select an amount from reasonably possible outcomes.
- When evaluating the reasonableness of disclosures about estimation uncertainty, use essentially the same types of considerations you applied when auditing accounting estimates recognized in the financial statements.

STEP 8. Evaluate whether there are indicators of possible management bias and, if there are, the implications for the audit. (CAS 540.32)

What

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, are indicators of possible management bias. When indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit. Where there is intention to mislead, management bias is fraudulent in nature.

Why

- Management may use considerable amounts of judgment in developing accounting estimates and related disclosures. Judgments are susceptible to bias that may increase the risk of material misstatement, including a misstatement due to fraud.

How

- Consider developing a tool or template that includes all accounting estimates to better enable you to look for patterns in the way management makes its accounting estimates and develops related disclosures.
- Discuss identified indicators of possible bias with management and perform other procedures to obtain evidence about implications of the indicators.
- Make your evaluation in relation to groups of accounting estimates or all the estimates in aggregate since, when considered individually, estimates may appear reasonable. Consider whether management's:
  - assessment of a need to change an estimate is subjective
  - judgments and decisions are favourable for management objectives; for example, management may make point estimates that provide them with a more favourable financial reporting outcome by consistently trending toward one end of the range of reasonable outcomes
  - selection of a point estimate indicates a pattern of optimism or pessimism

STEP 9. Make an overall evaluation based on audit procedures you performed. (CAS 540.33 – .35)

What

In applying CAS 330 to accounting estimates, the auditor shall evaluate, based on the audit procedures performed and audit evidence obtained, whether:

Enhanced "stand back" requirement, including a need to consider both the corroborative and contradictory audit evidence you obtained

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;
b. 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; and
c. Sufficient appropriate audit evidence has been obtained.

STEP 9. Make an overall evaluation based on audit procedures you performed. (CAS 540.33 – .35)

In making the evaluation required by paragraph 33(c), the auditor shall take into account 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 or the auditor's opinion on the financial statements in accordance with CAS 705.

The auditor shall determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. CAS 450 provides guidance on how the auditor may distinguish misstatements (whether factual, judgmental, or projected) for the auditor's evaluation of the effect of uncorrected misstatements on the financial statements.

Why

- An overall evaluation helps you to determine whether, for example:
  - — You have obtained sufficient appropriate audit evidence when your risk assessments have changed during the course of your audit. For example, you may have discovered that an accounting estimate is much higher on the spectrum of inherent risk than you originally assessed. An overall evaluation will help you to determine whether the changes you made to your audit procedures to respond to the higher assessed risk enabled you to obtain sufficient appropriate audit evidence.
  - — You have obtained sufficient appropriate audit evidence regarding the reasonableness of amounts within your estimate range when, for example, that range is a multiple of materiality for the financial statements as a whole.
  - — The requirements of the AFRF have been met. For example, when management has not recognized an accounting estimate, it may be useful to reconsider whether the recognition criteria in the AFRF were in fact met.
  - — Misstatements have been appropriately identified, including misstatements that may be indicative of fraud.
  - — Disclosures are appropriate, including those regarding estimation uncertainty, and supported by sufficient appropriate audit evidence.

How

- Identify whether any information that has come to your attention differs significantly from the information on which your risk assessment was based. For example, you may discover that an accounting estimate is significantly more complex than you originally contemplated. Therefore, you may conclude that inherent risk should be reassessed at a high level on the spectrum of inherent risk.
- When your audit evidence supports that a wide range for an estimate is appropriate in the circumstances, reconsider whether you have obtained sufficient appropriate audit evidence regarding the reasonableness of the amounts within the range.
- When your audit evidence supports a point estimate that differs from management's point estimate, the difference constitutes a misstatement. When your audit evidence supports a range that does not include management's point estimate, the misstatement is the difference between management's point estimate and the nearest point of the range supported by your audit evidence.
- Review identified misstatements for indicators of possible management bias that you may not have previously identified.

STEP 10. Document your audit work. (CAS 540.39)

What

The auditor shall include in the audit documentation:

a. Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;

b. The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level, taking into account the reasons (whether related to inherent risk or control risk) given to the assessment of those risks;

c. The auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty;

d. Indicators of possible management bias related to accounting estimates, if any, and the auditor's evaluation of the implications for the audit, as required by paragraph 32; and

e. Significant judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

Why

- To provide evidence that your audit was planned and performed in accordance with CAS 540 and other applicable CAS and that you exercised professional skepticism.
- To enable reviews of the work you performed and provide a record of matters of continuing significance to future audits.

How

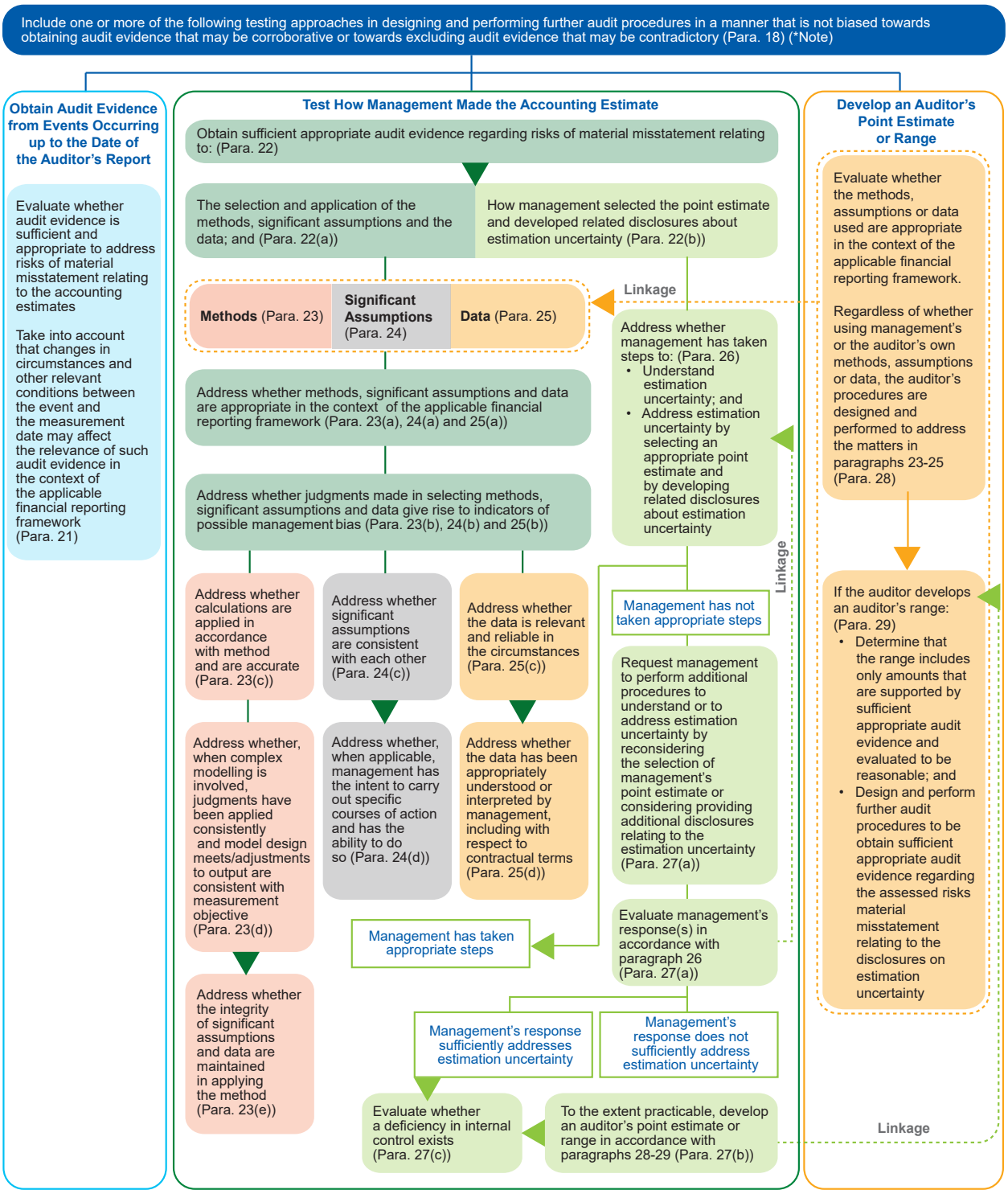
- In addition to the documentation requirements in CAS 540 (listed above), comply with the requirements and guidance in CAS 230, and with the documentation requirements in CAS 315 and CAS 330.
- The auditor is not required to document how every inherent risk factor was taken into account in identifying and assessing the risks of material misstatement in relation to each accounting estimate.

Appendix 3: Three Testing Approaches

ISA 540 (Revised) – Three Testing Approaches

This flowchart provides an overview of the key requirements relating to the three testing approaches, including their linkages.

IAASB



* **Note: Scalability**

The nature, timing and extent of the auditor's further audit procedures are affected by, for example: (Para. A84)

- The assessed risks of material misstatement, which affect the pervasiveness of the audit evidence needed and influence the approach the auditor selects to audit an accounting estimate
- The reasons for the assessed risks of material misstatement

Appendix 4: Linkages Between ISA 540 (Revised) and Other ISAs

Linkages between ISA 540 (Revised) and Other ISAs

IAASB

ISA 540 (Revised) deals with the auditor's responsibilities relating to accounting estimates and disclosures in an audit of financial statements. It includes requirements and guidance that refer to or expand on how other relevant ISAs are to be applied in relation to accounting estimates. This diagram shows the interrelationship of the requirements in ISA 540 (Revised) and the requirements in other ISAs to assist auditors in understanding the key linkages and in applying all relevant requirements in relation to the audit of accounting estimates and disclosures.

Risk Assessment Procedures and Related Activities

ISA 540 (Revised)	ISA 315 (Revised 2019)
Obtain an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control related to the entity's accounting estimates (Para. 13)	Obtain an understanding of the entity and its environment, the applicable financial reporting framework and the entity's system of internal control (Para. 19–27)

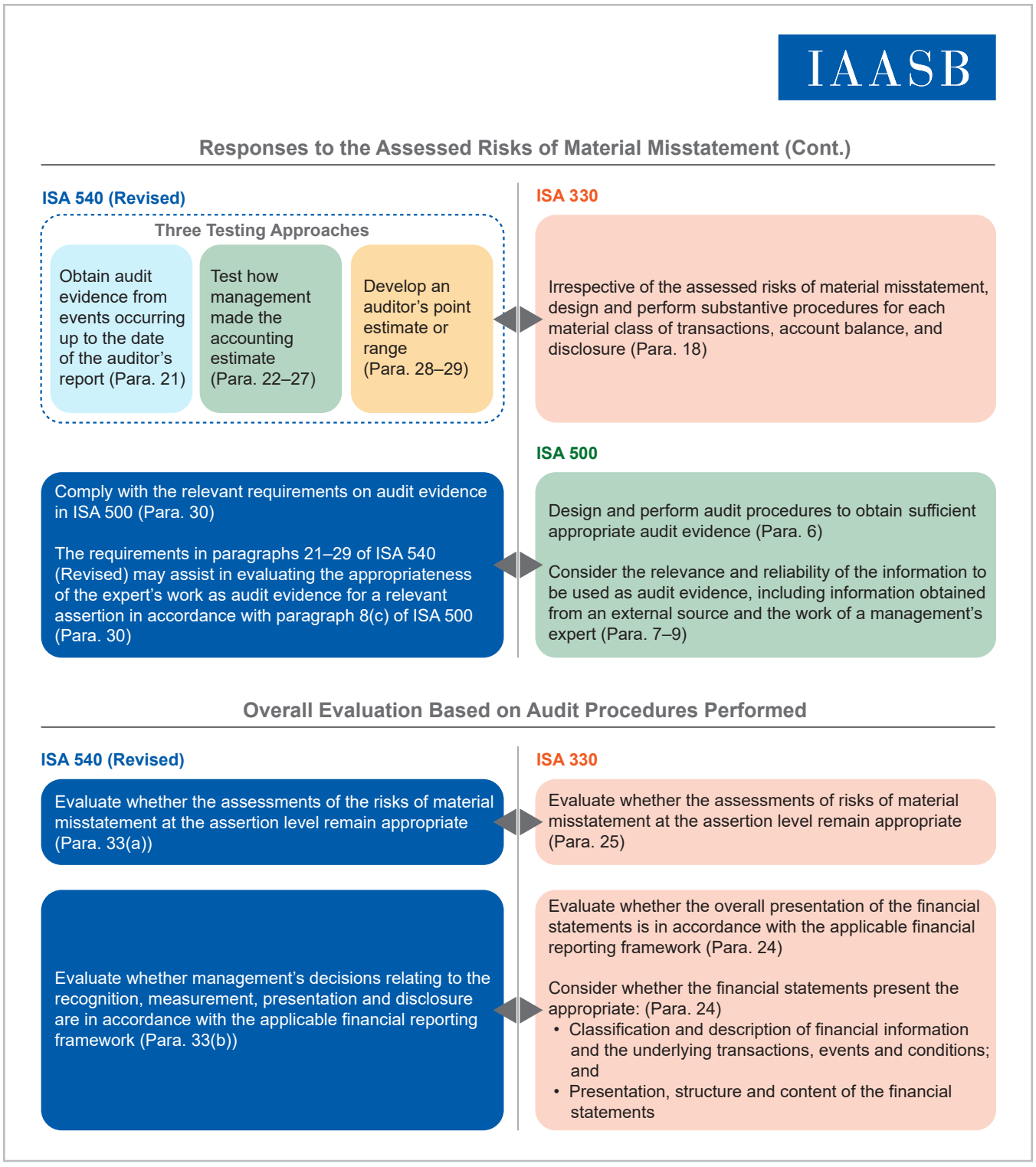
Identifying and Assessing the Risks of Material Misstatement

ISA 540 (Revised)	ISA 315 (Revised 2019)
Identify and assess the risks of material misstatement relating to an accounting estimate and related disclosures at the assertion level, including separately assessing inherent risk and control risk at the assertion level as required by CAS 315 (Para. 16) • Take into account the degree to which the accounting estimate is subject to, or affected by, estimation uncertainty, complexity, subjectivity and other inherent risk factors	For identified risks of material misstatement at the assertion level, assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, take into account how and the degree to which inherent risk factors affect the susceptibility of relevant assertions to misstatement (Para. 31) If the auditor plans to test the operating effectiveness of controls, assess control risk. If not, the assessment of control risk is the same as the assessment of inherent risk (Para. 34)
Determine whether any of the identified and assessed risks of material misstatement are a significant risk (Para. 17)	Determine whether any of the assessed risks are significant risks (Para. 32)
For significant risks, identify controls that address that risk and evaluate whether such controls have been designed effectively, and determine whether they have been implemented (Para. 17)	For significant risks, identify controls that address that risk, evaluate whether such controls have been designed effectively and determine whether they have been implemented (Para. 26(a), 26(a)(i))

IAASB

Responses to the Assessed Risks of Material Misstatement

ISA 540 (Revised)	ISA 330
Design and perform further audit procedures responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks (Para. 18) Take into account that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be (Para. 18)	Design and perform further audit procedures responsive to the assessed risks of material misstatement at the assertion level (Para. 6) Consider the reasons for the assessment given, including likelihood and magnitude of misstatement due to characteristics of significant classes of transactions, account balance or disclosure,and control risk assessment (Para. 7(a)) Obtain more persuasive evidence the higher the risk assessment (Para. 7(b)) Design and perform substantive procedures for each material class of transaction, account balance and disclosure (Para. 18)
Design and perform tests of operating effectiveness of controls if: (Para. 19) • The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively; or • Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level Obtain more persuasive audit evidence the greater the reliance on the effectiveness of a control (Para. 19)	Design and perform tests of operating effectiveness of controls if: (Para. 8) • The auditor plans to test the controls; or • Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level Obtain more persuasive evidence the greater the reliance on effectiveness of controls (Para. 9)
For a significant risk: (Para. 20) • Include tests of controls in the current period if the auditor plans to rely on controls • Include tests of details if the approach consists only of substantive procedures	If intending to rely on controls over a significant risk, test controls in the current period (Para. 15) For each significant risk, perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, include tests of details (Para. 21)


IAASB
Responses to the Assessed Risks of Material Misstatement (Cont.)
ISA 540 (Revised)
Three Testing Approaches
Obtain audit evidence from events occurring up to the date of the auditor's report (Para. 21)
Test how management made the accounting estimate (Para. 22–27)
Develop an auditor's point estimate or range (Para. 28–29)
ISA 330
Irrespective of the assessed risks of material misstatement, design and perform substantive procedures for each material class of transactions, account balance, and disclosure (Para. 18)
ISA 500
Comply with the relevant requirements on audit evidence in ISA 500 (Para. 30)
The requirements in paragraphs 21–29 of ISA 540 (Revised) may assist in evaluating the appropriateness of the expert's work as audit evidence for a relevant assertion in accordance with paragraph 8(c) of ISA 500 (Para. 30)
Design and perform audit procedures to obtain sufficient appropriate audit evidence (Para. 6)
Consider the relevance and reliability of the information to be used as audit evidence, including information obtained from an external source and the work of a management's expert (Para. 7–9)
Overall Evaluation Based on Audit Procedures Performed
ISA 540 (Revised)
Evaluate whether the assessments of the risks of material misstatement at the assertion level remain appropriate (Para. 33(a))
Evaluate whether management's decisions relating to the recognition, measurement, presentation and disclosure are in accordance with the applicable financial reporting framework (Para. 33(b))
ISA 330
Evaluate whether the assessments of risks of material misstatement at the assertion level remain appropriate (Para. 25)
Evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework (Para. 24)
Consider whether the financial statements present the appropriate: (Para. 24)
• Classification and description of financial information and the underlying transactions, events and conditions; and
• Presentation, structure and content of the financial statements


IAASB
Overall Evaluation Based on Audit Procedures Performed (Cont.)
ISA 540 (Revised)
Evaluate whether sufficient appropriate audit evidence has been obtained (Para. 33(c))
ISA 330
Conclude whether sufficient appropriate audit evidence has been obtained (Para. 26)
ISA 705 (Revised)
If unable to obtain sufficient appropriate audit evidence, evaluate the implications for the audit or the auditor's opinion on the financial statements (Para. 34)
Modify the opinion when the financial statements are not free from material misstatement or when unable to obtain sufficient appropriate evidence (Para. 6)
Determine the type of modification to the auditor's opinion (Para. 7–15)
Comply with the required form and content of the auditor's report when the opinion is modified (Para. 16–29)
ISA 330
Take into account all evidence obtained, whether corroborative or contradictory (Para. 34)
Consider all audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements (Para. 26)
Determine whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated (Para. 35)
Evaluate whether the overall presentation of the financial statements is in accordance with the applicable financial reporting framework (Para. 24)
ISA 700 (Revised)
For a fair presentation framework, evaluate whether disclosures achieve fair presentation of the financial statements (Para. 36(a))
For a fair presentation framework, evaluate whether financial statements achieve fair presentation (Para. 14)
For a compliance framework, evaluate whether disclosures are those necessary for financial statements not to be misleading (Para. 36(b))
For a compliance framework, discuss with management if financial statements are misleading (Para. 19)

IAASB

Written Representations

ISA 540 (Revised)

Request written representations from management and, when appropriate, those charged with governance (Para. 37)

ISA 580

Request written representations from management and, where appropriate, those charged with governance (Para. 6 and 9)

Communication with Those Charged with Governance, Management or Other Relevant Parties

ISA 540 (Revised)

Communicate with those charged with governance, management and other relevant parties as appropriate (Para. 38)

ISA 260 (Revised)

Communicate with those charged with governance views about significant qualitative aspects of the entity's accounting practices (Para. 16(a))

ISA 265

Communicate in writing with those charged with governance significant deficiencies in internal control (Para. 9)

Documentation

ISA 540 (Revised)

- Document key elements of understanding of the entity and its environment, including internal control related to accounting estimates (Para. 39(a))
- Document linkage of further audit procedures with the assessed risks of material misstatement at the assertion level (Para. 39(b))
- Document auditor's response(s) when management has not taken appropriate steps to understand and address estimation uncertainty (Para. 39(c))
- Document indicators of possible management bias related to accounting estimates, if any, and implications for the audit (Para. 39(d))
- Document significant judgments in determining whether accounting estimates and related disclosures are reasonable, or are misstated (Para. 39(e))

ISA 230

Prepare documentation that is sufficient to enable an experienced auditor to understand the nature, timing and extent of audit procedures performed, results and significant matters arising (Para. 8)

Record identifying characteristics of matters tested, who performed the work, date of completion, who reviewed the work and date of the review (Para. 9)

Document significant matters discussed with those charged with governance, management and others (Para. 10)

Document how the auditor addressed any inconsistency identified with a final conclusion on a significant matter (Para. 11)

Appendix 5: Scalability

Scalability

Although CAS 540 applies to all accounting estimates, the degree to which an accounting estimate is subject to estimation uncertainty will vary substantially. As a result, the nature, timing and extent of the risk assessment and further audit procedures (**tests of controls** and **substantive procedures**) will vary in relation to the:

- degree of inherent risk factors
- auditor's assessment of the related risks of material misstatement

Degree of inherent risk factors

The degree to which the accounting estimate is subject to inherent risk factors (estimation uncertainty, complexity, subjectivity and other):

To a lesser degree	To a greater degree
The auditor's **risk assessment procedures** and further audit procedures (**tests of controls** and **substantive procedures**) would be expected to be less extensive.	The auditor's **risk assessment procedures** and further audit procedures (**tests of controls** and **substantive procedures**) would be much more extensive.
For example: • There are few transactions or other events and conditions that give rise to the need for accounting estimates. • The applicable financial reporting requirements may be simple to apply. • There may be no relevant regulatory factors. • Accounting estimates may not require significant management judgments. • The process for making the accounting estimates may be less complex. • Fewer control activities that are identified. • The entity has a simple information system with fewer controls.	For example: • The entity has large amounts of transactions and/or encounters other events and conditions that give rise to the need for accounting estimates. • The applicable financial reporting requirements are complex to apply. • There are a few relevant regulator factors applicable to the entity. • The accounting estimates may require significant management judgments. • The process for making the accounting estimate involves complex models. • The entity has a sophisticated information system with more extensive controls.
The auditor's **risk assessment procedures** are likely to be less extensive and may be obtained primarily through inquiries of management with appropriate responsibilities for the financial statements and simple walk-throughs (e.g., inspection and/or observation) of management's process for making the accounting estimate.	The auditor's **risk assessment procedures** are likely to be different or more extensive than when the degree of measurement uncertainty was very low. Furthermore, the auditor may also conclude that it is necessary to add specialized skills or knowledge (e.g., through an additional team member or auditor's expert).

To a lesser degree	To a greater degree
The auditor may determine that there is no need to, or has decided not to, perform **tests of controls**.	The auditor may determine that substantive procedures alone are not enough and therefore will need to perform **tests of controls**.
The auditor's **substantive procedures** are responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks of material misstatement. For example, the assessment of inherent risk may be lower based on the degree to which the accounting estimate is subject to estimation uncertainty, complexity, subjectivity or other inherent risk factors. As a result, the less persuasive the audit evidence needs to be. (See Auditor's assessment of the related risks of material misstatement, below.)	The auditor's **substantive procedures** are responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks of material misstatement. For example, the assessment of inherent risk may be higher based on the degree to which the accounting estimate is subject to estimation uncertainty, complexity, subjectivity or other inherent risk factors. As a result, the more persuasive the audit evidence needs to be. (See Auditor's assessment of the related risks of material misstatement, below.)

Auditor's assessment of the related risks of material misstatement

The assessed risks of material misstatement affect the persuasiveness of the audit evidence needed and influence the approach[4] the auditor selects to audit an accounting estimate. The reasons for the assessment of inherent risk at the assertion level may result from one or more of the inherent risk factors of estimation uncertainty, complexity, subjectivity or other inherent risk factors:

Accounting estimate	Estimation uncertainty	Complexity	Subjectivity
An accounting estimate related to bonus accrual	Lower – because bonuses are paid to employees shortly after period-end (and known at the time the financial statements are prepared)	Lower – because it is a straightforward accrual	Lower – because the amount was paid
An accounting estimate related to litigation	Higher – because the amount is contingent on the outcome of the litigation	Lower – because of proposed assessment as per legal counsel	Higher – because of a single critical judgment
An accounting estimate for an obsolescence	Lower – because of the nature of the inventory	Higher – because there is a wide range of different inventory types	Lower – because little significant judgment is needed

4 The auditor's further audit procedures shall include one or more of the following approaches:
a. Obtaining audit evidence from events occurring up to the date of the auditor's report (see paragraph 21 of CAS 540);
b. Testing how management made the accounting estimate (see paragraphs 22 – 27 of CAS 540); or
c. Developing an auditor's point estimate or range (see paragraphs 28 – 29 of CAS 540).

Accounting estimate	Estimation uncertainty	Complexity	Subjectivity
Accounting estimates of expected credit losses / Insurance contract liabilities.	Higher – because of the inherent inability to measure them precisely and the impact of the other inherent risk factors (which are typically highly complex and subjective, therefore increasing the risk of estimation uncertainty)	Higher – because the expected credit losses / claims cannot be directly observed and may require the use of a complex model, which uses a complex set of historical data and assumptions about future developments, in a variety of entity-specific scenarios that may be difficult to predict	Higher – because significant judgments are made about future events or conditions

Scalability – Audits of Smaller Entities

In addition, when you are auditing a smaller entity, further considerations related to scalability may apply.[5] Such entities often have the following characteristics:

- few lines of business
- Uncomplicated transactions and other matters affecting accounting estimates, that require only simple recordkeeping
- Accounting estimates may be generated outside the general and subsidiary ledgers. Controls over the development of accounting estimates may be limited. For example, there may be no established risk assessment process, and limited opportunities for segregation of duties because there are few personnel. The owner-manager (or CEO of a not-for-profit organization) may provide effective oversight of the development of accounting estimates, but they also may be more able to override controls because the system of internal control is less structured. The owner-manager or CEO's role in making the accounting estimates may need to be taken into account when identifying the risks of material misstatement and when considering the risk of management bias.

5 See paragraph A22 of CAS 540.