



# Exposure Draft

## Proposed Canadian Auditing Standard

# Auditing Accounting Estimates and Related Disclosures

**May 2017**

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**COMMENTS TO THE AASB MUST BE RECEIVED BY  
July 7, 2017**

**COMMENTS TO THE IAASB MUST BE RECEIVED BY  
August 1, 2017**

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**Respondents are asked to email their comment letters  
(in a Word file) to:**

**[ed.assurancestds@cpacanada.ca](mailto:ed.assurancestds@cpacanada.ca)**

**Please address your comments to:**

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**Director, Auditing and Assurance Standards**

**Auditing and Assurance Standards Board**

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**This Exposure Draft reflects proposals made by the International Auditing and Assurance Standards Board that the Auditing and Assurance Standards Board (AASB) intends to adopt, subject to deliberating comments received, as Canadian generally accepted auditing standards.**

**Individuals and organizations are invited to send written comments on the Exposure Draft proposals. Comments are requested from those who agree with the Exposure Draft as well as from those who do not.**

**Comments are most helpful if they are related to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning. All comments received by the AASB will be available on the website shortly after the comment deadline, unless confidentiality is requested. The request for confidentiality must be stated explicitly within the response.**

## Highlights

The Auditing and Assurance Standards Board (AASB) proposes, subject to comments received following exposure, to adopt with appropriate amendments, if any:

- proposed International Standard on Auditing (ISA) 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*; and
- conforming amendments to:
  - ISA 260, *Communication with Those Charged with Governance*;
  - ISA 500, *Audit Evidence*; and
  - ISA 580, *Written Representations*,

issued by the International Auditing and Assurance Standards Board (IAASB). The result would be revised respective Canadian Auditing Standards (CASs).

This Exposure Draft consists of:

- proposed changes;
- a link to the IAASB's Exposure Draft, including its Explanatory Memorandum;
- a description of the AASB's process for adopting ISAs;
- a discussion of proposed significant Canadian amendments;
- a proposed effective date; and
- key changes to CAS 540 proposed in the Exposure Draft.

Please review "**Comments requested**" on page ii for information on preparing your response to this Exposure Draft.

## Proposed changes

The Exposure Draft proposes a number of key changes, which include:

- enhanced approach to risk assessment;
- more focused effort to identify and assess the risk of material misstatement;
- enhanced retrospective review;
- greater emphasis on the use of specialized skills or knowledge;
- enhanced linking of required responses to assessed risk;
- enhanced focus on the use of an auditor's point estimate or range;
- greater emphasis on disclosures;
- expanded overall evaluation based on audit procedures performed;
- additional written representations of management;
- greater emphasis on communications with those charged with governance or management; and

- additional information on measurement bases relevant in making accounting estimates.

The significance of accounting estimates to audits of all types of entities may make the impact of the Exposure Draft particularly significant for audit practices. Appendix I provides a more detailed overview of key changes proposed to CAS 540 in the Exposure Draft.

## IAASB Exposure Draft

The IAASB's Exposure Draft, "[Auditing Accounting Estimates and Related Disclosures](#)," is available on the IAASB website.

In addition to the text of proposed ISA 540 (Revised), the Exposure Draft includes an Explanatory Memorandum, which provides background to, and an explanation for, the proposed revisions to extant ISA 540.

## Process for adopting ISAs

In adopting the ISAs as CASs, the AASB issues as a Canadian exposure draft, every IAASB exposure draft of a proposed ISA. However, in doing so, the AASB recognizes that it has a vital role to play in monitoring changes made by the IAASB to ensure that standards remain in the Canadian public interest and that adoption of an ISA is not automatic. The AASB follows amendment criteria set out in the Appendix II that allow the AASB to make amendments in specific circumstances.

Other key attributes of the process for adopting ISAs as CASs are set out below:

- The deadline for responding to an exposure draft provides the time needed for the AASB to consider the responses of Canadian stakeholders in developing its response to an IAASB exposure draft.
- The AASB normally uses the same effective date for the CASs as the IAASB does for the ISAs.
- The AASB makes CASs available shortly after they are approved, so Canadian auditors can become familiar with them and prepare to implement them by the effective date.

## Proposed significant Canadian amendments

The AASB proposes no Canadian amendments to the proposed revised ISAs.

## Proposed effective date

The IAASB proposes that the revised ISAs be effective for audits of financial statements for periods ending approximately 18 months after the approval of the final ISAs. The revised CASs would have the same effective date as the revised ISAs. Auditors will be permitted to apply these revised CASs before the effective date.

## Comments requested

Comments are most helpful if they are related to a specific paragraph or group of paragraphs. Any comments that express disagreement with the proposals in the Exposure Draft should clearly explain the problem and include a suggested alternative, supported by specific reasoning. When a respondent agrees with proposals in the Exposure Draft, it will be helpful for the AASB to be made aware of this view.

### *Responding to the IAASB's Exposure Draft*

Stakeholders are asked to provide comments on the IAASB's Exposure Draft directly to the IAASB, and provide the AASB with a copy of the response. The AASB will take these comments into account in drafting its own response to the IAASB's Exposure Draft. Respondents are asked not to include

comments on matters particular to the Canadian environment in their responses to the IAASB. Such comments should be included only in responses sent to the AASB.

Please refer to the “Guide for Respondents” contained in the IAASB’s Exposure Draft and respond to the specific questions therein.

### *Providing comments to the AASB*

The AASB would appreciate receiving responses to the questions set out below, in addition to receiving a copy of the response to the IAASB’s Exposure Draft.

In responding to the questions below, the AASB invites firms of all sizes to field test the requirements in proposed CAS 540 and communicate the outcome in its response letter. Lessons learned from field testing will provide the AASB with a better understanding of the practical implications of the proposals.

1. Do you believe that the proposed CAS 540 is capable of being clearly understood and consistently interpreted and applied?
2. Recognizing that the proposals will apply to all accounting estimates and related disclosures in an audit of financial statements, do you believe that considerations for estimates of all sizes and complexities have been dealt with appropriately?
3. Recognizing that the proposals will apply to audits of all sizes, do you believe that considerations in the audit of small entities have been dealt with appropriately?
4. Recognizing that the proposals will apply to audits of entities in all industries, do you foresee any difficulties in applying the proposals to audits of financial statements of entities in specific industries?
5. Recognizing that financial statements may be prepared using one of several possible financial reporting frameworks (for example, International Financial Reporting Standards, accounting standards for private enterprises or Public Sector Accounting Standards), do you foresee any difficulties in applying the proposals to audits of financial statements in accordance with any of the financial reporting frameworks used in Canada?
6. Do you believe the proposals are sufficiently comprehensive for the purposes of assisting auditors, management and those charged with governance to communicate effectively with respect to auditing accounting estimates?
7. Do you believe the AASB should make any Canadian amendments to the proposed ISAs? If so, please include your reasoning and describe their nature and extent. Any amendments proposed would need to meet the criteria set out in Appendix II.
8. Do you believe any of the requirements in the proposals could create initial implementation difficulties, despite the guidance provided? If so, please explain.

The deadline for providing your comments to the AASB on the above is July 7, 2017.

## **Key changes to CAS 540 proposed in the Exposure Draft**

This Appendix provides an overview of the key changes to CAS 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, proposed in the Exposure Draft. This is not a complete list of changes. To fully understand the proposed changes, readers are encouraged to read the full text of the Exposure Draft.

The revisions aim to establish more robust requirements and appropriate guidance to foster audit quality. Cross-references to the IAASB's Explanatory Memorandum to proposed ISA 540 (Revised) are included below as they provide further background to, and an explanation for, the proposed revisions to extant ISA 540.

### *Enhanced approach to risk assessment*

Paragraph 10 of the Exposure Draft introduces risk assessment procedures that are not in CAS 540. These include requirements for the auditor to obtain an understanding of:

- the regulatory factors, if any, relevant to accounting estimates;
- the nature of the accounting estimates and related disclosures that the auditor expects to be included in the entity's financial statements;
- the process used to select data, including the source(s) of that data and how management identifies significant data; and
- how the risk of management bias is identified and addressed.

Paragraph 10 of the Exposure Draft also gives greater emphasis to, and expands on, the requirements and guidance included in CAS 540 to obtain an understanding of:

- the use of models, and factors that may be relevant in obtaining that understanding; and
- each of the components of internal control as they relate to making accounting estimates.

(See paragraphs 15-16 of the IAASB's Explanatory Memorandum.)

### *More focused effort to identify and assess the risks of material misstatement*

The Exposure Draft introduces additional factors, not in CAS 540, for the auditor to take into account when identifying and assessing the risks of material misstatement. Paragraph 13 of the Exposure Draft requires the auditor to take into account the extent to which the accounting estimate is subject to, or affected by:

- complexity in making the accounting estimate;
- the use of judgment by management and the potential for management bias; and
- the estimation uncertainty associated with the accounting estimate.

The Introduction section, application material (paragraphs A79-A93), and Appendix 2 to the Exposure Draft provide further material to aid understanding of each of the factors.

Paragraph 10 of CAS 540 requires the auditor to take into account estimation uncertainty alone when identifying and assessing the risks of material misstatement.

(See paragraphs 17-18 of the IAASB's Explanatory Memorandum.)

## *Enhanced retrospective review*

Paragraph 11 and related guidance of the Exposure Draft expand on the requirements and guidance included in paragraph 9 of CAS 540 by highlighting the retrospective review of the outcome of accounting estimates can also be performed over several periods or over a shorter period (such as a half-year or quarterly). In addition, the Exposure Draft clarifies that the auditor is required to take into account the characteristics of the accounting estimate in determining the nature and extent of the retrospective review.

(See paragraph 20 of the IAASB's Explanatory Memorandum.)

## *Greater emphasis on the use of specialized skills or knowledge*

Paragraph 12 of the Exposure Draft introduces a requirement that is not in CAS 540 for the auditor to determine whether specialized skills or knowledge are required in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. This is in addition to the requirement in paragraph 14 of the Exposure Draft (which comes from paragraph 14 of CAS 540) to determine whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures.

(See paragraph 21 of the IAASB's Explanatory Memorandum.)

## *Enhanced linking of required responses to assessed risks*

The Exposure Draft enhances the links between the identified risks of material misstatement and the auditor's work effort. The proposed changes include the following new requirements:

- Paragraphs 15(a) and 15(b) of the Exposure Draft require the auditor to design and perform further audit procedures based on whether the level of inherent risk is low or not low.
- Paragraph 15(b) of the Exposure Draft requires, when inherent risk is not low, the auditor to perform procedures that respond to the reasons for the risks of material misstatement (complexity, judgment and estimation uncertainty).
- Paragraph 16 of the Exposure Draft reinforces the need to test operating effectiveness of controls when the auditor intends to rely on those controls relating to accounting estimates or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

The Exposure Draft does not include specific requirements for significant risks that exist in paragraphs 15-17 of CAS 540 because they would also be applicable in relation to many risks that may not be determined to be significant. Rather, paragraph 15 of the Exposure Draft requires the auditor's procedures to respond to the risks of material misstatement, including significant risks, and indicates that the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be.

(See paragraphs 19 and 22-31 of the IAASB's Explanatory Memorandum.)

## *Enhanced focus on the use of an auditor's point estimate or range*

Paragraphs 15 and 19 of the Exposure Draft retain the option in paragraph 13 of CAS 540 for the auditor to develop an auditor's point estimate or range to evaluate management's point estimate. Paragraph 20 of the Exposure Draft introduces a requirement that is not in CAS 540 to only include in the range amounts that:

- are supported by the audit evidence; and
- the auditor evaluated as reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework.

(See paragraphs 32-39 of the IAASB's Explanatory Memorandum.)

### *Greater emphasis on disclosures*

The Exposure Draft includes greater emphasis on the important role of disclosures relating to accounting estimates in financial reporting. The changes are as follows

- Paragraph 19 of the Exposure Draft requires the auditor to obtain sufficient appropriate audit evidence about disclosures for all accounting estimates that describe estimation uncertainty, instead of only disclosures about accounting estimates that give rise to significant risks as in paragraph 20 of CAS 540.
- Paragraph 21 of the Exposure Draft requires that the auditor obtain sufficient appropriate audit evidence about whether disclosures are “reasonable”, instead of “adequate” in CAS 540. The use of the term “reasonable” for auditing both accounting estimates and disclosures illustrates that both have the same level of importance.
- Paragraph 21 of the Exposure Draft includes additional considerations, not in CAS 540, in the case of fair presentation or compliance frameworks.

(See paragraphs 11-13 and 43-45 of the IAASB's Explanatory Memorandum.)

### *Expanded overall evaluation based on audit procedures performed*

The Exposure Draft includes an overall evaluation requirement that is not in CAS 540. Paragraph 22 of the Exposure Draft requires, for each accounting estimate with an inherent risk that is not low, the auditor evaluate, based on the audit procedures performed and audit evidence obtained, whether:

- the assessed risk of material misstatement is still appropriate;
- sufficient appropriate audit evidence has been obtained; and
- management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates are in accordance with the applicable financial reporting framework.

Paragraph 23 of the Exposure Draft expands the requirement in paragraph 18 in CAS 540 for the auditor to consider all relevant audit evidence obtained, whether corroborative or contradictory, in evaluating whether accounting estimates and related disclosures are reasonable or misstated. This highlights the important element of professional skepticism.

(See paragraphs 40-42 of the IAASB's Explanatory Memorandum.)

### *Additional written representations of management*

Paragraph 25 of the Exposure Draft includes additional requirements, not in paragraph 22 of CAS 540, with respect to written representations. It requires the auditor to:

- obtain written representations about the “methods” and “significant data”, rather than only “significant assumptions”, used in making the accounting estimates; and
- consider whether representations are needed about specific accounting estimates, including with respect to the methods, assumptions, or data used.

### *Greater emphasis on communications with those charged with governance or management*

Paragraph 26 of the Exposure Draft includes a requirement, not in CAS 540, with respect to communication with those charged with governance or management. It requires the auditor to consider communicating the extent to which the accounting estimates and their related disclosures are affected by, or subject to, complexity, judgment, estimation uncertainty, or other relevant factors.

(See paragraphs 46-47 of the IAASB's Explanatory Memorandum.)

### *Additional information on measurement bases relevant in making accounting estimates*

Appendix 1 of the Exposure Draft, which is not in CAS 540, explains the different types of measurement bases that may be relevant in making an accounting estimate. The Appendix provides context for the auditor's consideration of the extent to which the complexity, judgment, and estimation uncertainty may be inherent in a particular measurement basis.

(See paragraph 49 of the IAASB's Explanatory Memorandum.)

## Criteria for amending ISAs when adopting them as Canadian Auditing Standards

With respect to the adoption of ISAs, the AASB's overriding goal is to adopt ISAs into the Assurance Handbook without amendment. However, there may be circumstances where amendments are required. The following sets out the limited circumstances when the AASB makes amendments to ISAs:

1. The AASB limits additions to an ISA to those required to comply with Canadian legal and regulatory requirements.<sup>1</sup>
2. The AASB limits deletions from, or other amendments to, an ISA to the following:
  - (a) the elimination of options (alternatives) provided for in the ISA;
  - (b) requirements or guidance, the application of which Canadian law or regulation does not permit, or which require amendments to be consistent with law or regulation; and
  - (c) requirements or guidance, where the ISA recognizes that different practices may apply in different jurisdictions and Canada is such a jurisdiction.
3. The AASB may make amendments to an ISA with respect to requirements or guidance that do not fall within 1 or 2 above when it believes that there are circumstances particular to the Canadian environment where such amendments are required to serve the Canadian public interest and maintain the quality of auditing and reporting in Canada.
4. To the extent possible, amendments that are:
  - (a) additions to an ISA will not be inconsistent with the current requirements or guidance in the ISA; and
  - (b) deletions from, or other amendments to, an ISA will be replaced by an appropriate alternative that achieves the objective of the deleted requirement.

Proposed amendments to an ISA are highlighted in exposure drafts of proposed Canadian standards. The AASB indicates the reasoning for the amendments and respondents are invited to comment on them, including when the amendment will not result in convergence with the ISA in accordance with the International Auditing and Assurance Standards Board's guide for national standard setters. Amendments to ISAs are separately identified in the final Handbook material.

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<sup>1</sup> Canadian incorporating and other governing legislation often requires entities to prepare financial statements in accordance with Canadian GAAP. Accordingly, if Canadian GAAP necessitates a different audit response in Canada, these differences fall within the definition of a legal or regulatory requirement.

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