

ASA 540

(October 2009)

Explanatory Statement

ASA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

Issued by the **Auditing and Assurance Standards Board**



Australian Government

Auditing and Assurance Standards Board

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Contact Details

Auditing and Assurance Standards Board	Phone: (03) 8080 7400
Level 7	Fax: (03) 8080 7450
600 Bourke Street	E-mail: enquiries@auasb.gov.au
Melbourne Victoria 3000	
AUSTRALIA	

Postal Address:
PO Box 204
Collins Street West
Melbourne Victoria 8007
AUSTRALIA

Reasons for Issuing Auditing Standard ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

The Auditing and Assurance Standards Board (AUASB) issues Auditing Standard ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* pursuant to the requirements of the legislative provisions and the Strategic Direction explained below.

The AUASB is an independent statutory board of the Australian Government established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act). Under section 336 of the *Corporations Act 2001* (the Act), the AUASB may make Auditing Standards for the purposes of the corporations legislation. These Auditing Standards are legislative instruments under the *Legislative Instruments Act 2003*.

Under the Strategic Direction given to the AUASB by the Financial Reporting Council (FRC), the AUASB is required to have regard to any programme initiated by the International Auditing and Assurance Standards Board (IAASB) for the revision and enhancement of the International Standards on Auditing (ISAs) and to make appropriate consequential amendments to the Australian Auditing Standards. The IAASB has undertaken a programme to redraft, and in some cases, revise, in “clarity” format, the entire suite of ISAs. Accordingly, the AUASB has decided to revise and redraft the Australian Auditing Standards using the equivalent redrafted ISAs.

The Auditing Standard conforms with ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

Operative Date

ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* is operative for financial reporting periods commencing on or after 1 January 2010.

Purpose of Auditing Standard ASA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

The purpose of the Auditing Standard is to establish requirements and to provide application and other explanatory material to auditors regarding their responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of a financial report. Specifically, the Auditing Standard expands on how other relevant Auditing Standards are to be applied in relation to accounting estimates.

Main Features

This Auditing Standard requires the auditor to:

- (a) obtain an understanding of the entity and its environment to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates;
- (b) design and perform audit procedures to respond to the assessed risks of material misstatement of an entity's accounting estimates;
- (c) perform further substantive procedures in response to any identified significant risks;
- (d) evaluate the reasonableness of accounting estimates, and their disclosure in the financial report; and
- (e) obtain written representations from management about the reasonableness of significant assumptions used by it in making accounting estimates.

Preamble and Overall Objectives

ASA 540 is to be read in conjunction with ASA 101 *Preamble to Australian Auditing Standards*, which sets out the intentions of the AUASB on how the Australian Auditing Standards, operative for financial reporting periods commencing on or after 1 January 2010, are to be understood, interpreted and applied. ASA 540 is to be read also in conjunction with ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*.

Process of making Australian Auditing Standards

The AUASB's Strategic Direction, *inter alia*, provides that the AUASB develop Australian Auditing Standards that:

- have a clear public interest focus and are of the highest quality;
- use the International Standards on Auditing (ISAs) of the International Auditing and Assurance Standards Board (IAASB) as the underlying standards;
- conform with the Australian regulatory environment; and
- are capable of enforcement.

In implementing the FRC's Strategic Direction, the AUASB has undertaken a process of revision and redrafting of the Australian Auditing Standards that has:

- updated the form, layout and content of the Australian Auditing Standards;
- addressed the legal enforceability of mandatory obligations;
- maintained clarity of the auditor's obligations;
- incorporated appropriate references to Australian laws and regulations;
- clearly identified, by use of the prefix "Aus", AUASB additions to paragraphs in the requirements or the application and other explanatory material; and
- included other amendments as necessary.

Consultation Process prior to issuing the Auditing Standard

The AUASB has consulted publicly as part of its due process in developing the Auditing Standard. Exposure Draft ED 12/08 *Proposed Auditing Standard: Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Re-issuance of ASA 540), was issued on 15 September 2008 with a 30 day comment period.

Explanatory Statement ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

As an integral part of its consultation with the public, the AUASB sought comments on specific questions including:

- the completeness and accuracy of references in the Auditing Standard to relevant laws and regulations;
- the significant costs, if any, and benefits, of compliance with any additional requirements under the Auditing Standard; and
- whether or not there exist any matters of public interest affecting the issuance of the Auditing Standard.

Submissions were received by the AUASB and these were considered as part of the development and finalisation of the Auditing Standard.

Regulation Impact Statement

A *Regulation Impact Statement* (RIS) has been prepared in connection with the redrafting of Australian Auditing Standards in “clarity” format, including ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*.

The RIS has considered both the expected benefits and expected costs of the introduction of clarified auditing standards, including comments provided by stakeholders during the redrafting process. It concluded that expected benefits to users of audit services, users of audit reports, auditors and the Australian economy in general are, on balance, likely to outweigh expected costs.

Main Differences from ASA 540 *Audit of Accounting Estimates* (April 2006) and ASA 545 *Auditing Fair Value Measurements and Disclosures* (April 2006)

The main differences between the Auditing Standard and the two Auditing Standards that it supersedes, ASA 540 and ASA 545, are:

1. Auditing Standard ASA 540 is written in the “clarity” format using the equivalent International Standard on Auditing (ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*) as the underlying Auditing Standard. Consequently, the format, layout, and paragraph numbering styles are different from the extant Auditing Standard.

Explanatory Statement ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

2. In accordance with normal updating practice, ASA 540 (using ISA 540 as the underlying standard) has been subject to a major revision in addition to redrafting in “clarity” format. The revision has resulted in an Auditing Standard that now combines the requirements and guidance previously contained in two separate Auditing Standards: extant ASA 540 and extant ASA 545. In ASA 540, the requirements and application and other explanatory material paragraphs are either:
 - (a) new paragraphs;
 - (b) elevations of extant guidance paragraphs; or
 - (c) rewording of extant paragraphs.
3. The following requirements included in Auditing Standard ASA 540 are in part, or full, additional to the main additional requirements to the extant Auditing Standards:
 - (a) When performing risk assessment procedures and related activities to obtain an understanding of the entity and its environment, including the entity’s internal control, as required by ASA 315, the auditor shall obtain an understanding of the following in order to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates.
 - The requirements of the applicable financial reporting framework relevant to accounting estimates, including related disclosures.
 - How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognised or disclosed in the financial report. In obtaining this understanding, the auditor shall make enquiries of management about changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.
 - How management makes the accounting estimates, and an understanding of the data on which they are based, including:

Explanatory Statement ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- The method, including where applicable the model, used in making the accounting estimate;
 - Relevant controls;
 - Whether management has used an expert;
 - The assumptions underlying the accounting estimates;
 - Whether there has been or ought to have been a change from the prior period in the methods for making the accounting estimates, and if so, why; and
 - Whether and, if so, how management has assessed the effect of estimation uncertainty. (Ref: Para. 8)
- (b) Based on the assessed risks of material misstatement, the auditor shall determine:
 - Whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and
 - Whether the methods for making the accounting estimates are appropriate and have been applied consistently, and whether changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances. (Ref: Para. 12)
- (c) For accounting estimates that give rise to significant risks, in addition to other substantive procedures performed to meet the requirements of ASA 330, the auditor shall evaluate the following:
 - How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.

Explanatory Statement ASA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

- Whether the significant assumptions used by management are reasonable.
 - Where relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so. (Ref: Para. 15)
- (d) If, in the auditor's judgement, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, the auditor shall, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate. (Ref: Para. 16)
- (e) The auditor shall include in the audit documentation:
- The basis for the auditor's conclusions about the reasonableness of accounting estimates and their disclosure that give rise to significant risks;
 - Indicators of possible management bias, if any; and
 - The auditor's evaluation of any indicators of possible management bias in making accounting estimates, including whether the circumstances producing the indicators of bias represent a risk of material misstatement due to fraud. (Ref: Para. 23)
4. Significant Application and Other Explanatory Material, linked to the additional obligations listed at 3. above, is also included in the Auditing Standard.