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Auditing accounting estimates

Strengthening audit quality

Implications of the current economic conditions on auditing estimates

The current macroeconomic environment is characterized by heightened uncertainty due to volatility in interest rates, persistent inflationary pressures, constrained credit markets, and geopolitical instability. These conditions increase estimation uncertainty, complexity, and subjectivity in the measurement of accounting estimates, and elevate the risks of material misstatement, particularly in areas involving significant management judgment.

This is especially relevant for accounting estimates, such as fair value measurements, impairment of assets and assessment of material uncertainty related to an entity's going concern assumption. This increased risk of material misstatement requires auditors to exercise a higher level of professional skepticism.

Many audit files inspected by CPAB involve estimates with a high degree of estimation uncertainty

Canadian Auditing Standard (CAS) 540, *Auditing Accounting Estimates and Related Disclosures*, has been effective for audits of financial statements for periods beginning on or after December 15, 2019.

Inspection results indicate that audit quality in this area has improved since the revised standard became effective. However, as external factors increase the level of estimation uncertainty in many accounting estimates, CPAB continues to identify deficiencies in the sufficiency and appropriateness of audit work performed on these critical accounting estimates.

This publication builds on the key messages in CPAB’s 2021 publication, [Auditing accounting estimates](#), and should be read in conjunction with it, by:

- Expanding on common application challenges identified through our inspections, including illustrative scenarios.
- Reinforcing the role of the firm’s system of quality management in supporting the consistent execution of audits.

Auditors are encouraged to review our previous publication for additional context and examples of the key themes discussed.

Common application challenges related to auditing accounting estimates

CPAB’s inspections of audit files have continued to identify recurring challenges in the auditing of accounting estimates as follows:¹

Deficiencies in management’s estimate approach were not effectively challenged

CAS 540, paragraphs 22-29

- Auditors did not effectively challenge deficiencies in management’s estimate or approach and there was no evidence that the auditor requested management to perform additional procedures to understand and address the level of estimation uncertainty.

Inappropriate use of point estimates or ranges

CAS 540, paragraph 27

- Auditors developed a point estimate or range without obtaining a sufficient understanding of how management assessed and addressed the level of estimation uncertainty.
- Auditors developed a point estimate or range without appropriate consideration of independence.

No assessment of the impact of identified deficiencies on internal controls

CAS 540, paragraphs 17, 23 and 27

- Where deficiencies were identified in management’s model, auditors did not perform an assessment of the impact on the reporting issuer’s internal controls.

Insufficient or no consideration of contradictory evidence

CAS 540 paragraphs 18 and 34

- Auditors focused on corroborating management’s position without adequately evaluating the basis for their judgements or sufficiently identifying and assessing contradictory evidence.

Lack of evidence of a stand-back assessment

CAS 540, paragraphs 33-36

- Auditors did not perform or document an effective stand-back assessment to objectively evaluate all audit evidence or robustly challenge management’s conclusions.

¹Refer to the 2021 publication for illustrative examples for each of these themes.

How a strong system of quality management supports audit quality

CPAB inspections continue to observe a strong correlation between a robust system of quality management and more consistent audit quality outcomes, including in areas requiring significant auditor judgment such as accounting estimates.² Effective firm-level resourcing controls and processes are critical to ensuring engagement teams have the appropriate expertise and capacity to respond to the risk of material misstatement related to estimates with higher estimation uncertainty.

Resourcing controls

CPAB inspections have identified that the following firm-level processes and controls can positively impact the audit procedures performed at the engagement level.³

Assessment of engagement team expertise and capacity at acceptance and continuance

Firms that assess engagement team expertise and capacity at the acceptance and continuance stage are better positioned to address complex estimates. Practices observed include:

- Assigning engagement partners and managers with relevant industry experience.
- Identifying the need for specialists early in the planning process to ensure the team has appropriate expertise.
- Assessing resource availability during initial acceptance and continuance to confirm sufficient capacity.

Examples

Acceptance

- A firm accepted a new reporting issuer in the mortgage lending industry and assigned an engagement partner and manager with relevant industry experience. The firm also assessed the engagement budget to ensure that there was sufficient capacity to appropriately plan, challenge assumptions, and review management's judgments for the complex accounting estimates.
- During the acceptance process, a firm identified that auditing Level 3 investments would require specialized valuation expertise. In response, the firm engaged an external valuation specialist to support the audit.

Continuance

- During the continuance process, a firm identified recurring impairment indicators in an industry under sustained economic pressure where management had consistently concluded that no impairment was required. The firm recognized that the audit effort would increase and, to address capacity risks, the firm added experienced team members and scheduled additional partner and manager review for testing, evaluation of bias, and review.

²CPAB's 2021 publication also highlighted practices that continue to be relevant. Additional resources and insights on systems of quality management are available in [CPAB's past publications on this topic](#).

³The examples provided are illustrative in nature and should not be considered exhaustive. They have been observed at audit firms of varying sizes and can be applied proportionately based on the nature, risk and complexity of the firm's portfolio of audit engagements.

Ongoing monitoring of resources throughout the audit

Regular resource check-ins help the audit firm to be proactive and respond to changing risks on a timely basis. Practices observed include:

- Partners participate in periodic all-partners’ check-ins to reassess whether engagement staffing, experience, and time allocation remain appropriate in light of audit progress and emerging risks.
- Firms monitor hours incurred to expected audit milestones (e.g., planning, risk assessment, execution, review) to assess whether planned procedures and reviews have been completed as the audit progresses.
- Firms monitor overtime and high workloads of senior engagement team members (individuals responsible for the supervision and review) to identify potential compression of audit work, reduced time for supervision and review, or risks to professional judgment.

Examples

Budget to actual hour monitoring

- Monitoring showed that hours incurred were significantly below budget at key stages of the audit, indicating that planned procedures or reviews may not yet have been performed. This triggered follow-up with the engagement team to confirm progress against audit milestones and reassess the sufficiency of planned procedures.

Overtime and workload compression monitoring

- Firm-level workload reports identified sustained overtime by senior engagement team members late in the audit cycle, indicating potential compression of audit work and limited time for supervision, review, and stand-back procedures. This information was escalated to leadership and used to reassess resourcing, timelines, and the need for additional support.



Consultation requirements for higher-risk audit areas

Firm-level policies that set expectations around the use of internal or external consultation when certain complexities arise help ensure that appropriate discussions are held on challenging areas. Common consultation triggers may include:

- Reporting issuers operating in industries significantly impacted by external economic or regulatory factors (such as interest rate volatility or tariffs), and impairment indicators are present, but no impairment has been recognized.
- Significant investments in private entities where the valuation involves Level 3 inputs and the engagement team has not engaged a valuation expert.
- Events or conditions are identified during the audit that may cast significant doubt on the reporting issuer's ability to continue as a going concern.

Examples

Impairment related consultations

- A reporting issuer operating in an industry under significant economic pressure identified impairment indicators for certain long-lived assets. Management concluded that no impairment was required based on forecasted cash flows and key assumptions. In accordance with firm consultation policies, the engagement team consulted with audit quality leadership to obtain concurrence that the planned audit procedures were appropriately responsive to the identified risk of material misstatement, including management's key assumptions and the need for specialist involvement.
- During the continuance process, a firm identified recurring impairment indicators in an industry under sustained economic pressure where management had consistently concluded there was no impairment. In accordance with firm policy, the engagement team consulted with audit quality leadership to assess engagement risk and determine whether additional expertise was required for the upcoming audit.

Fair value hierarchy consultations

- A reporting issuer held a significant investment in a private entity measured at fair value using Level 3 inputs. The engagement team initially did not plan to involve a valuation expert. In accordance with firm consultation requirements for significant Level 3 valuations, where no specialist involvement was planned, the engagement team consulted with audit quality leadership. The consultation focused on obtaining oversight and challenge of whether the planned audit approach was sufficient to address the risk of material misstatement. The consultation identified additional valuation risks, including sensitivity to unobservable inputs and estimation uncertainty. As a result, a valuation expert was engaged to ensure the completeness of identified risks and that audit procedures were responsive.

Firm-level media monitoring

Firm-level or centralized monitoring that proactively monitor events or conditions that may impact the audit help ensure that teams have sufficient capacity and expertise. Practices observed include:

- Monitoring public information sources, including press releases, regulatory filings and news outlets, to identify events that may affect the audit or engagement scope.
- Identifying significant events, including acquisitions, restructurings, financing activities or changes to senior management.

Examples

- Through firm-level media monitoring, a firm identified public disclosures and industry news indicating sustained economic pressures affecting a reporting issuer’s sector, including declining demand and asset closures announced by peers. This information was communicated to the engagement team by audit quality leadership, prompting consideration of whether impairment indicators were present despite management’s conclusion that no impairment was required. As a result, it was determined that the involvement of additional expertise was required to appropriately address the complexities associated with the impairment assessment.

Intellectual resources

CPAB has also observed that audit quality over auditing estimates can be supported using firm-level intellectual resources. Observed practices include:

- Firm-wide meetings or learning sessions discussing the results of external inspections and internal quality monitoring, external publications, or macroeconomic developments.
- Templates that incorporate standards, guidance and practical examples.
- Templates that outline the scope and responsibilities between auditors and auditor’s experts, supported by guidance.

Examples

- In response to inspection findings related to auditing accounting estimates, a firm reviewed and updated its audit templates and supporting guidance for evaluating significant assumptions, estimation uncertainty, and management bias. Firm-wide training was delivered to explain inspection findings and the purpose of the updated templates and to reinforce how engagement teams should complete them to appropriately address the requirements of auditing accounting estimates.
- A firm incorporated CPAB’s joint publication with the Chartered Business Valuators Institute into targeted training sessions to support engagement teams in auditing valuation related accounting estimates. The publication was used as a reference point during the training to illustrate key valuation concepts, clarify the respective roles of auditors and valuation specialists, and demonstrate how the guidance can be applied when auditing estimates involving significant judgment and estimation uncertainty.

Tone at the top

Challenging management's significant judgements and estimates

Improvements in audit quality related to accounting estimates are unlikely to be sustained through standards and tools alone. Firm leadership plays a critical role in reinforcing an environment that supports effective challenge of management, timely consultation with subject matter specialists, and appropriate escalation of issues, particularly in areas involving significant judgment and heightened estimation uncertainty. This includes establishing an environment that encourages a consultative culture that empowers engagement teams to exercise professional skepticism and escalate to firm leadership when barriers to effective challenge are encountered.

Addressing estimation uncertainty

CAS 540 requires auditors to understand how management has identified and addressed estimation uncertainty. Where necessary, auditors may need to require management to perform additional procedures or enhance their analysis, to respond to that uncertainty. Effective challenge of management, supported by strong two-way communication with the audit committee, is critical to audit quality in this area.



Appendix A - Illustrative scenarios

These scenarios are based on actual significant findings, however facts have been modified or excluded to safeguard the identities of the reporting issuers.

Scenario one: Impairment of goodwill and intangible assets

Background

A reporting issuer has material goodwill and intangible assets at the end of the reporting period. Due to changes in operating performance and market conditions, management identified indicators of impairment and performed an impairment analysis under the applicable financial reporting framework.

The impairment assessment relied on a cash flow-based valuation model incorporating significant management judgment, including forecasted revenues, growth rates, discount rates, and the allocation of corporate overhead costs. Based on this analysis, management concluded that no impairment was required.

Audit approach

The auditor identified the valuation of goodwill and intangible assets as a significant risk and responded primarily through obtaining an understanding of management's model, inquiry, and the use of an auditor's expert.

Specifically, the auditor:

- Obtained an understanding of management's impairment model by reviewing forecasted cash flows, growth rates, discount rates and cost allocations through inquiries with management about how they developed key assumptions.
- Identified that management's model excluded net cash flows directly attributable to corporate overhead.
- Engaged an auditor's valuation expert who concluded that the discount rate used by management in the valuation model was inappropriate.
- Determined that management's model had not sufficiently addressed the estimation uncertainty due to excluded cash flows and concerns with the discount rate. The auditor did not require management to revise the model or perform additional procedures to address the level of estimation uncertainty.
- Developed an auditor's point estimate using a discount rate that was the mid-point between management's discount rate and the auditor's expert rate. The auditor did not assess whether developing a point estimate compromised independence given the level of estimation uncertainty and the issues identified in management's model.
- Agreed with management's conclusion that no impairment existed, without performing a stand-back assessment to evaluate whether there were indications of management bias.

Findings

CPAB identified deficiencies relating to the risk assessment procedures and sufficiency of the procedures performed by the engagement team to:

- Evaluate whether the controls relevant to the related significant risk had been effectively designed and implemented, given management used an inappropriate discount rate and excluded relevant cash flows in their model.⁴
- Challenge management's forecasts and verify that relevant cash flows were included in management's model because the engagement team did not:
 - Request management to perform additional procedures to address the estimation uncertainty related to internally generated cash flows that were significant assumptions to support management's conclusion that there was no impairment.
 - Consider whether it was impracticable to develop an auditor's point estimate without compromising auditor independence given management had not addressed the level of estimation uncertainty in estimating cash flows.⁵ As complexity and subjectivity increase, it becomes less likely that an auditor can appropriately develop a point estimate without compromising auditor independence.
- Evaluate whether the judgments made in selecting the assumptions and data (e.g., discount rate, net cash flows, corporate overhead costs) within the model gave rise to potential management bias.⁶

⁴ CAS 315, paragraphs 26 and 27; CAS 540, paragraphs 17 and 27.

⁵ CAS 540, paragraphs 26-27 and A116.

⁶ CAS 540, paragraphs 24, 25, 32 and 35-36.

Scenario two: Allowance for credit losses⁷

Background

The reporting issuer provides asset-based financing across various industries in Canada and has a diverse loan portfolio with varying borrower profiles, collateral types, and geographic exposures. The allowance for credit losses (ACL) is material and is determined using a single off-the-shelf expected credit loss model applied across the entire portfolio. The model relies on internally generated data and incorporates significant management judgment, including staging and significant increase in credit risk assessments, as well as forward looking economic assumptions. At the reporting date, economic conditions increased estimation uncertainty and the sensitivity of the ACL to management's assumptions.

Audit approach

The auditor identified a significant risk over the valuation of the ACL and responded primarily through control reliance and substantive procedures focused on key assumptions and calculations. Specifically, the auditor:

- Designed procedures to test (i) a management review control, which consisted of management's review of the overall allowance outcome and key reports generated by the model and (ii) selected model assumptions and outputs.
- Did not identify or test additional controls relevant to the significant risk (e.g., controls over data, model governance, or key judgments embedded in staging/significant increase in credit risk).
- Determined the model as "off-the-shelf" and concluded that no evaluation of model design was necessary. Because the model was proprietary, the auditor did not replicate the model; testing of model outputs was limited to mathematical recalculation using assumptions and data as determined by the model.
- Tested selected assumptions requiring judgment (e.g., staging and significant increase in credit risk) and performed sample testing of loans across stages to evaluate whether staging was appropriate.
- Where key support was unavailable (e.g., evidence of payments after year-end or borrower financial information), the auditor evaluated the evidence that was available and concluded management's staging assessment was appropriate, without obtaining or resolving the missing/contradictory evidence.
- Agreed key model inputs by tracing to management prepared schedules generated from internal systems, without performing procedures specifically addressing the completeness and accuracy of those schedules and underlying system reports.
- Did not involve valuation or information technology specialists to support testing of the model data flows, or specialized judgments.

⁷ The audit of ACL is particularly challenging for auditors as there is often high estimation uncertainty in the measurement of the ACL. The determination of ACL typically involves complex models; multiple data sources; forward-looking information; significant judgment in the selection and weighting of macro-economic variables; collateral valuation; judgments in determining significant increase in credit risk.

Findings

CPAB identified deficiencies relating to the risk assessment procedures and sufficiency of the procedures performed by the engagement team to:

- Determine whether management's review control was sufficiently precise to address the risk of material misstatement identified and provide an appropriate basis for auditor's intended reliance.⁸
- Challenge whether grouping all loans into one portfolio is appropriate given the different nature of the loans, collaterals and geography.⁹
- Evaluate whether the off-the-shelf model used to determine the ACL was fit for purpose considering the comparability of the loan portfolio of the off-the-shelf model and the reporting issuer's loan portfolio.¹⁰
- Assess whether any additional qualitative or quantitative overlays judgment necessary to reflect uncertainties of the current and forecasted economic situation that may not be captured through the model.¹¹
- Test certain assumptions used by management in the model that required judgment including staging and significant increase in credit risk.¹²
- Test the data used by management in the model as procedures were limited to agreeing to management-prepared schedules without consideration of the completeness and accuracy of those schedules.¹³
- Evaluate contradictory evidence on appropriateness of management's assumptions.¹⁴
- Evaluate indicators of possible management bias even if management's judgments were concluded to be individually reasonable.¹⁵

⁸ CAS 315, paragraphs 26, CAS 540, paragraphs 17 and 19.

⁹ CAS 540, paragraphs 22-23.

¹⁰ CAS 315, paragraphs 26, CAS 540, paragraphs 17 and 19.

¹¹ CAS 315, paragraphs 26, CAS 540, paragraphs 17 and 19.

¹² CAS 540, paragraph 24.

¹³ CAS 540, paragraph 25.

¹⁴ CAS 540, paragraphs 18 and 34.

¹⁵ CAS 540, paragraphs 23-25 and 35-36.

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