

## Supplement to Agenda Item 2-A

### Initial Revisions to Key Paragraphs of ED-ISA 540

**Note:** The shading in the document highlights areas of the proposed revisions that are intended to demonstrate scalability, and the Task Force would welcome comments and suggestions about how this might be further emphasized.

ED-ISA 540	Proposed Changes	Possible Key Points For Application Material
<p><b>Identifying and Assessing the Risks of Material Misstatement</b></p> <p>13. In applying ISA 315 (Revised), the auditor is required to identify and assess the risks of material misstatement, at the financial statement and assertion levels, and to determine whether any of the risks of material misstatement identified are, in the auditor’s judgment, significant risks. In identifying and assessing risks of material misstatements in relation to an accounting estimate, the auditor shall take into account the extent to which the accounting estimate is subject to, or affected by, one or more, relevant factors, including: (Ref: Para. A71–A78)</p> <p style="padding-left: 20px;">(a) Complexity in making the accounting estimate, including:</p> <p style="padding-left: 40px;">(i) The extent to which the method, including modelling, involves specialized skills or knowledge; and (Ref: Para. A79–A81)</p>	<p><b>Identifying and Assessing the Risks of Material Misstatement</b></p> <p>13. In identifying and assessing the risks of material misstatement relating to accounting estimates and related disclosures, as required by ISA 315 (Revised), the auditor shall take into account the extent of estimation uncertainty, [including] [as well as] the extent to which the methods, assumptions and data used in making the accounting estimate are subject to, or affected by, complexity, subjectivity, or other relevant factors. (Ref: Para. A71–A78)</p> <p>13A. The auditor shall determine whether any of the risks of material misstatement identified are, in the auditor’s judgment, significant risks.</p>	<ul style="list-style-type: none"> <li>• As defined, estimation uncertainty is the susceptibility of an accounting estimate to an inherent lack of precision in its measurement (ED paragraph 9). The extent to which accounting estimates are subject to or affected by estimation uncertainty is often related closely to the extent to which they are subject to or affected by complexity and subjectivity. Accordingly, the auditor’s identification and assessment of the risks of material misstatement relating to accounting estimates, and the auditor’s responses to those assessed risks, are affected by relevant risk factors, and the interrelationship among them. (ED paragraph 2, with some revision)</li> <li>• The relevance and significance of risk factors may vary from one estimate to another, and may be of lesser importance when dealing with simple accounting estimates. For example, for simple accounting estimates with less</li> </ul>

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<p>(ii) The difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data; (Ref: Para. A82)</p> <p>(b) The need for the use of judgment by management and the potential for management bias, including with respect to methods, assumptions, and data; and (Ref: Para. A83–A85)</p> <p>(c) Estimation uncertainty, including the extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the assumptions and data used. (Ref: Para. A86–A93)</p>		<p>complexity, less subjectivity, and lower levels of estimation uncertainty, this may lead to the identification of fewer risks or risks at the lower end of the risk spectrum; likewise, for difficult or complex accounting estimates that involve more subjectivity and have higher levels of estimation uncertainty, this may lead to the identification of more risks of material misstatement.</p> <ul style="list-style-type: none"> <li>• Furthermore, when there is more complexity, more subjectivity, and higher levels of estimation uncertainty surrounding the making of an accounting estimate, these factors may directly affect the number and nature of identified risks of material misstatement, the assessment of such risks, and ultimately the persuasiveness of the audit evidence needed.</li> <li>• The information about complexity, subjectivity and estimation uncertainty related to the accounting estimates obtained in connection with the auditor’s understanding required by ED paragraph 10 also may help inform the auditor’s identification and assessment of the risks of material misstatement at</li> </ul>

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		<p>the assertion level.</p> <ul style="list-style-type: none"> <li>• In identifying and assessing the risks of material misstatement at the assertion level, the auditor may take into account: <ul style="list-style-type: none"> <li>a) The complexity of the method used for making the accounting estimate, including the use of models;</li> <li>b) The number, complexity and source of significant assumptions and [significant] data used in making the accounting estimate;</li> <li>c) The extent to which the accounting estimate is sensitive to the selection of different methods or to variations in the assumptions and data used.</li> </ul> </li> <li>• The reasons for the auditor's assessment of the risks of material misstatement may result from one or more of the risk factors. For example: ... (ED paragraph A74 – decide whether to keep)</li> <li>• Other relevant risk factors (ED paragraph A78)</li> <li>• Other application material in ED paragraphs A79-A93, modified as</li> </ul>

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		deemed necessary.
<p><b>Responses to the Assessed Risks of Material Misstatement</b></p> <p>14. In responding to the assessed risks of material misstatement related to accounting estimates, the auditor shall determine whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures. (Ref: Para. A67–A70)</p>	<p><b>Responses to the Assessed Risks of Material Misstatement</b></p> <p>14. <b>[To be discussed later]</b> In responding to the assessed risks of material misstatement related to accounting estimates, the auditor shall determine whether specialized skills or knowledge are required to design and perform audit procedures, or to evaluate the results of those procedures. (Ref: Para. A67–A70)</p>	
<p>15. In applying ISA 330, the auditor is required to design and perform further audit procedures to respond to the assessed risks of material misstatement, including significant risks, at the assertion level. In doing so: (Ref: Para A94–A95)</p> <p>(a) When inherent risk is low, the auditor shall determine whether one or more of the following further audit procedures would provide sufficient appropriate audit evidence regarding the assessed risk(s) of material misstatement in the circumstances: (Ref: Para A96)</p>	<p>15. In designing and performing further audit procedures as required by ISA 330, the auditor shall design an approach to testing the accounting estimate that is responsive to the reasons for the assessed risks of material misstatement, and that includes one or more of the following: (Ref: Para A94–A95)</p> <p>(a) Determining whether events occurring up to the date of the auditor’s report provide audit evidence regarding the accounting estimate;</p>	<ul style="list-style-type: none"> <li>• In designing further audit procedures, ISA 330 requires the auditor to consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including the likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance or disclosure (that is, the inherent risk), and whether the risk assessment takes account of relevant controls (that is, control risk), thereby requiring the auditor to obtain audit evidence to</li> </ul>

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<p>(i) Obtaining audit evidence about events occurring up to the date of the auditor's report;</p> <p>(ii) Testing how management made the accounting estimate and the data on which it is based; or</p> <p>(iii) Developing a point estimate or range based on available audit evidence to evaluate management's point estimate.</p> <p>(b) When inherent risk is not low, the auditor's further audit procedures shall include procedures to obtain audit evidence about the matters in paragraphs 17–20, when applicable. (Ref: Para A97)</p> <p>The auditor's further audit procedures shall be responsive to the reasons for the assessment given to the risk of material misstatement in accordance with paragraph 13, recognizing that the higher the assessed risk of material</p>	<p>(b) Testing how management made the accounting estimate; or</p> <p>(c) Developing a point estimate or range based on available audit evidence to evaluate management's point estimate.</p> <p>15A. 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. In addition, as required by ISA 330,<sup>1</sup> the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure related to accounting estimates, irrespective of the assessed risk of material misstatement.</p>	<p>determine whether the controls are operating effectively. (ED paragraph A94)</p> <ul style="list-style-type: none"> <li>• In designing the audit procedures responsive to the risks, the auditor should also take into account the nature of the estimate and the underlying effects of the relevant factors (see part (c) of this question for further views), as well as the appropriateness of management's process to make the estimate.</li> <li>• Consider whether additional application material may be needed to link the first sentence of paragraph 15A to the spectrum of risk concept.</li> <li>• Consider whether additional application material may be needed to explain the reference to paragraph 18 of ISA 330 in paragraph 15A in the context of accounting estimates.</li> <li>• Guidance on when it may be appropriate to select more than one strategy, including when it is appropriate for the auditor to develop</li> </ul>

<sup>1</sup> ISA 330, paragraph 18

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misstatement the more persuasive the audit evidence needs to be.		an independent point estimate or range. <ul style="list-style-type: none"> <li>• ED paragraphs A98-A100, modified as necessary</li> </ul>
16. If the auditor intends to rely on controls relating to accounting estimates, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to their operating effectiveness. <sup>2</sup> (Ref: Para A98–A100)	16. If the auditor intends to rely on controls relating to accounting estimates, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to their operating effectiveness. <sup>3</sup> For significant risks, the auditor’s procedures shall include testing controls in the current period if the auditor plans to rely on controls over a risk, and tests of details when the approach consists only of substantive procedures. <sup>4</sup> (Ref: Para A98–A100)	
<i>Complexity</i> 17. In complying with paragraph 15(b), when the reasons for the assessment given to	<i>Determining Whether Events Occurring up to the Date of the Auditor’s Report Provide Audit Evidence Regarding the Accounting Estimate</i>	<ul style="list-style-type: none"> <li>• Consider application material in extant paragraphs A62-A67</li> </ul>

<sup>2</sup> ISA 330, paragraph 8

<sup>3</sup> ISA 330, paragraph 8

<sup>4</sup> ISA 330, paragraph 15

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<p>the risk of material misstatement include complexity related to management's use of a complex method (including complex modelling), or when management's method otherwise involves the use of specialized skills or knowledge, the auditor shall obtain sufficient appropriate audit evidence about the following matters: (Ref: Para A101–A104)</p> <p>(a) Whether the method, and significant data and significant assumptions, are appropriate in the context of the applicable financial reporting framework;</p> <p>(b) Whether significant data is relevant and reliable.<sup>5</sup></p> <p>(c) Whether management has appropriately understood or interpreted significant data, including with respect to contractual terms. (Ref: Para. A105)</p> <p>(d) Whether the integrity of significant data and significant assumptions has been maintained in applying the method; and (Ref: Para. A106)</p>	<p>(15a)</p> <p>17. When the auditor's further audit procedures include obtaining evidence about events occurring up to the date of the auditor's report, the auditor shall evaluate whether the audit evidence:</p> <p>(a) is sufficient, reliable and relevant to the accounting estimate, and</p> <p>(b) supports or contradicts the accounting estimate,</p> <p>taking into account that changes in circumstances and other relevant conditions between the event or transaction date and the measurement date may affect its relevance to the accounting estimate at the measurement date.</p> <p><i>Testing How Management Made the Accounting Estimate (15(b))</i></p> <p>17A. In testing how management made the accounting estimate, the nature, timing, and extent of the auditor's further audit procedures shall be designed to obtain sufficient appropriate audit evidence about the matters in paragraphs 17B-</p>	<ul style="list-style-type: none"> <li>Consider whether additional application material to paragraph 17 is needed (i.e., beyond the reference to the reasons for the assessed risks of material misstatement) to further demonstrate scalability</li> </ul>

<sup>5</sup> ISA 500, paragraph 7

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<p>(e) Whether the calculations are mathematically accurate and appropriately applied.</p> <p><i>Judgment</i></p> <p>18. In complying with paragraph 15(b), when the reasons for the assessment given to the risk of material misstatement include the need for the use of judgment by management, the auditor shall obtain sufficient appropriate audit evidence about the following matters:</p> <p>(a) When the accounting estimate involves the use of significant data or significant assumptions:</p> <p>(i) Whether management's judgments regarding the selection and use of the method and the significant data and significant assumptions: (Ref: Para A107)</p> <p>a. Are appropriate in the context of the measurement objectives and other requirements of the applicable financial</p>	<p>17D below relating to the methods, assumptions and data used by management in making the accounting estimate.</p> <p>Methods</p> <p>17B. With respect to the methods used by management to make the accounting estimate, the auditor shall obtain sufficient appropriate audit evidence about the following matters: (Ref: Para A101–A104)</p> <p>(d) Whether the method selected is appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework, and is appropriate for the business, industry, and environment in which the entity operates;</p> <p>(e) If applicable, whether changes from previous periods in the method used are appropriate;</p> <p>(f) Whether the calculations are mathematically accurate and appropriately applied;</p> <p>(g) When management's application</p>	<ul style="list-style-type: none"> <li>• ED paragraphs A101-A112, with additional guidance as deemed necessary</li> <li>• Consider application material to link to ISA 500 regarding testing the accuracy and completeness of the data.</li> </ul>

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<p>reporting framework; or</p> <p>b. Give rise to indicators of possible management bias.</p> <p>(ii) Whether management's judgments about changes from previous periods in the method or the significant data or significant assumptions, are appropriate (Ref: Para. A108–A110).</p> <p>(iii) Whether significant assumptions are consistent with each other and with those used in other accounting estimates or with assumptions used in other areas of the entity's business activities.</p> <p>(b) When relevant to the appropriateness of the significant assumptions or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific</p>	<p>of the method involves complex modelling, whether judgments made have been applied consistently and whether, when applicable:</p> <p>(i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;</p> <p>(ii) Changes, if any, from the previous period's model are appropriate in the circumstances; and</p> <p>(iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances (Ref: Para A112)</p> <p>(h) Whether the integrity of significant assumptions and data has been maintained in applying</p>	

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<p>courses of action and has the ability to do so. (Ref: Para. A111);</p> <p>(c) When management's application of the method involves complex modelling, whether judgments made have been applied consistently and whether, when applicable:</p> <p>(i) The design of the model meets the measurement objective of the applicable financial reporting framework and is appropriate in the circumstances;</p> <p>(ii) Changes, if any, from the previous period's model are appropriate in the circumstances; and</p> <p>(iii) Adjustments, if any, to the output of the model are consistent with the measurement objective of the applicable financial reporting framework and are appropriate in the circumstances. (Ref: Para A112)</p>	<p>the method.</p> <p>Significant Assumptions</p> <p>17C. With respect to the significant assumptions selected by management, the auditor shall obtain sufficient appropriate audit evidence about the following matters:</p> <p>(a) Whether the significant assumptions selected for use:</p> <p>(i) Are appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate; and</p> <p>(ii) Give rise to indicators of possible management bias;</p> <p>(b) Whether significant assumptions are consistent with each other and with those used in other accounting estimates, or with assumptions used in other areas of the entity's business activities;</p>	

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	<p>(c) When relevant to the appropriateness of the significant assumptions or the appropriate application of the requirements of the applicable financial reporting framework, whether management has the intent to carry out specific courses of action and has the ability to do so.</p> <p>[Significant] Data</p> <p>17D. With respect to the [significant] data used by management in making the accounting estimate, the auditor shall obtain sufficient appropriate audit evidence about the following matters:</p> <p>(a) Whether the [significant] data selected for use:</p> <p>(i) Is appropriate in the context of the measurement objectives and other requirements of the applicable financial reporting framework, and, if applicable, changes from prior periods are appropriate;</p>	

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	<p>(ii) Gives rise to indicators of possible management bias; and</p> <p>(iii) Is relevant and reliable</p> <p>(b) Whether management has appropriately understood or interpreted [significant] data, including with respect to contractual terms.</p> <p>Developing an Auditor's Point Estimate or Range</p> <p>18. [To be discussed later]</p>	
Paragraph 19 and 20 [To be discussed later]	Paragraph 19 and 20 [To be discussed later]	