



ISA 540 (Revised): Comments to the Exposure Draft

Rich Sharko, IAASB Member and Chair of the ISA 540 Task Force

Marc Pickeur, IAASB Member and Co-Chair of the ISA 540 Task Force

IAASB Meeting, New York

Agenda Item 2

October 2017

IAASB

**International Auditing
and Assurance
Standards Board**

Overview

- The Task Force's activities since the September Board meeting
- Responses to the ED
- Scalability, including the threshold of low/not low inherent risk
- Risk factors
- Responding to the assessed risks of material misstatement
- Restructuring the work effort requirements
- Conforming and consequential amendments to ISA 500

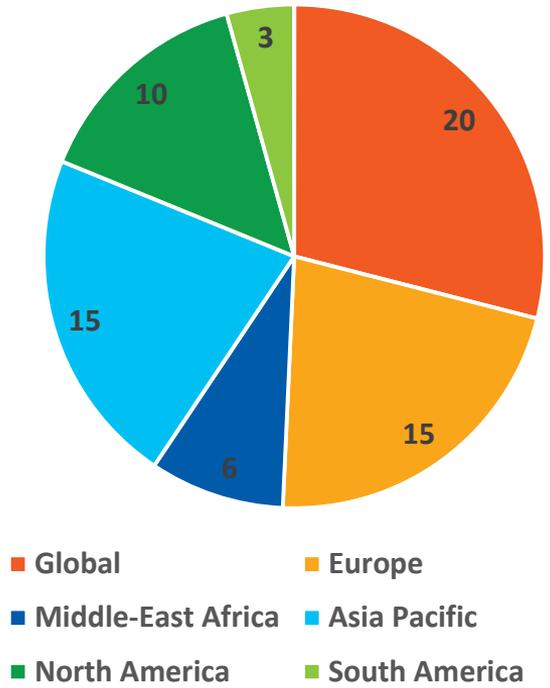
The Task Force's Activities Since September Board Meeting

- One physical Task Force meeting and one teleconference
- Outreach performed with several stakeholders, including representatives of:
 - Basel Committee on Banking Supervision
 - Global Public Policy Committee
 - Committee of European Auditing Oversight Bodies
 - Office of the Superintendent of Financial Institutions Canada
 - International Accounting Standards Board
- SMPC's IAASB Rapid Response Task Force Letter
 - Supportive of Task Force's direction on scalability (including removal of the threshold) and structuring the work effort around data, assumptions and methods

Responses to ED - Overview

Total	69
Regulators and Oversight Authorities	9
National Auditing Standard Setters	9
Accounting Firms	10
Member Bodies and Other Professional Organizations	25
Public Sector Organizations	8
Preparers of Financial Statements	1
Those Charged with Governance	1
Academics	1
Investors	2
Individuals and Others	3

Geographic Areas



Four Monitoring Group Members responded: Basel Committee, IAIS, IFIAR, and IOSCO

Responses to the ED - Exposure Draft Questions

- The ED requested responses to eight questions covering how ED-540 addresses:
 - Evolving financial reporting frameworks (Q1)
 - Professional skepticism (Q2)
 - Scalability (Q3)
 - Risk assessment and response (Q4), including views on the risk factors and the objectives-based requirements
 - Ranges (Q5)
 - Determination of misstatements (Q6)
 - Conforming and consequential amendments to ISA 500 (Q7)
 - Translations and effective date (Q8)

Responses to the ED – Progress on Analyses

- Task Force summarized respondent's comments and have discusses a proposed direction for:
 - Question 3: Scalability
 - Question 4: Risk assessment and response, including views on the risk factors and the objectives-based requirements
 - Question 7: Conforming and consequential amendments to ISA 500
- The Task Force's analysis of the letters is ongoing throughout the finalization of ISA 540
- The Monitoring Group's responses to Q3, Q4 and Q7 are highlighted in the analysis documents (**Agenda Items 2-B to 2-D**)
- Staff prepared a preliminary analysis of responses to questions 1, 2, 5, 6, 8 and the other general comments received (supplement A-F to Agenda Item 2). The Task Force will discuss these analysis documents and a response thereto in November
 - Staff from the NZAuASB and CAASB supported the Task Force in preparing the preliminary analysis

Matter for IAASB Consideration

- 1) Based on Member's reading of the comment letters, the IAASB is asked for its views on whether the analysis documents included as Agenda Items 2-B to 2-D capture the key points in the comment letters. If not, what else would need to be added and considered by the Task Force? What additional issues have IAASB members identified?

Scalability – What did we hear on scalability?

- Many respondents believed that ED-540 was sufficiently scalable, including indicating support for the use of a threshold as a way to drive scalability
- Many others expressed concerns about whether the structure of ED-540 would achieve the desired objective of scalability, including with regard to the threshold of “low inherent risk” included in paragraph 15 of ED-540. Concerns noted included:
 - ED-540 is too complex or confusing for “simple” estimates
 - Substantial levels of documentation will be required
 - Risk assessment requirements are too onerous for simple estimates
- The flow chart was seen to be helpful

Scalability – What did we hear about the threshold?

- Many respondents opposed the threshold or expressed concern and sought clarification thereon. Concerns included:
 - Whether the threshold is operable
 - Whether the threshold’s use of “low inherent risk” is aligned with other ISAs (including ISA 315 (Revised))
 - How to apply the threshold to material accounting estimates with low inherent risk
- Respondents who supported the threshold approach noted that:
 - It is not necessary to perform the same level of work for an estimate with ‘low’ inherent risk as for an estimate with higher inherent risk.
 - The auditor should focus on the higher risk estimates given their greater relevance to audits of financial institutions

Scalability - Task Force's Response

- Task Force discussed pros and cons of retaining and removing the threshold:
 - May be possible to clarify the threshold by including more AM. However, would not alleviate concerns about complexity and practical application of ED-540
 - If the threshold is removed, scalability needs to be reinforced and demonstrated in other ways
- The Task Force concluded that the threshold could be removed, and scalability, simplicity, and practicality could be maintained by reinforcing the existing concept of the spectrum of risk, and drawing upon the existing material in ISA 315 (Revised) and ISA 330. In addition, the Task Force:
 - Proposes to include examples showing how to apply the requirements for the most simple accounting estimates
 - Will consider including a flowchart with the release of the standard showing the flow of the requirements

Matter for IAASB Consideration

2) The IAASB is asked for its views on the direction proposed by the Task Force in relation to the scalability of proposed ISA 540 (Revised), including:

- The consideration of removing the threshold of low/not low inherent risk
- Further emphasizing the spectrum of risk to demonstrate scalability. What could be done to reinforce the spectrum of risk in proposed ISA 540 (Revised)?
- Using examples to further demonstrate scalability

Matter for IAASB Consideration

- 3) The IAASB is asked for its views on whether there are other comments related to scalability that the IAASB believes would be useful for the Task Force to consider

Risk Factors – What Did We Hear?

- Support for considering the risk factors in identifying and assessing the RoMM
- Mixed views about whether the response to the assessed RoMM should be based around each risk factor:
 - Interrelationships make it challenging to determine the appropriate response to the assessed RoMM
 - Not consistent with how management makes, and auditor audits, accounting estimates. Management and auditor most commonly consider accounting estimates in terms of data, assumptions and methods
- Other views expressed include:
 - Explain the role of ‘other’ risk factors better
 - Explain the relationship between risk factors and assertions
 - Driver of RoMM is estimation uncertainty - complexity and judgement are related

Risk Factors – Task Force’s Response

- No significant changes to the role of risk factors in identifying and assessing RoMM
 - Include reference to ‘other’ risk factors in requirement
 - Enhance the AM based on comments received
- Explain the application of the risk factors throughout the standard
 - How the risk factors relate to data, assumptions and methods
 - The link between the risk factors and assertions
 - Risk factors are not “what could go wrong” but inform *why* there is a risk that the accounting estimate may be materially misstated
- No longer articulate the response to the assessed RoMM based around the risk factors – see revisions in next section

Matter for IAASB Consideration

- 4) The IAASB is asked for its views on the proposed direction with respect to paragraph 13 in ED-540 regarding the identification and assessment of the risks of material misstatement

Responding to the assessed RoMM – What Did We Hear?

- Structure of paragraphs 14-20 is unclear, complex, too granular/prescriptive and not sufficiently objectives-based. This may result in:
 - Difficulty in applying the standard in practice
 - Inconsistencies in application and interpretation
 - Checklist mentality
 - Less professional judgment and professional skepticism being applied
- With respect to the structure respondents noted that:
 - The testing strategies for low inherent risk accounting estimates (paragraph 15(a) in ED-540) are applicable to all accounting estimates
 - The testing objectives in paragraphs 17–20 may also be applicable for estimates with low inherent risk
 - Certain testing objectives in paragraphs 17–20 are not always related to a single risk factor

Responding to the assessed RoMM – Task Force’s Response

- Include the 3 testing strategies ((i) test how management made the accounting estimate, (ii) develop a point estimate or range or (iii) use audit evidence from events occurring up to the date of the auditor’s report) in a separate requirement that applies to all ROMMs
- Structure the work effort around selecting one or more testing strategies, then focusing the testing on data, assumptions and methods
 - Structuring the work effort around testing strategies reflects how an estimate is developed, and keeping the objective based requirements is responsive to those stakeholders who supported the level of granularity in ED-540
 - Makes designing the response to the RoMM more logical and consistent with how management makes the accounting estimate

Responding to the assessed RoMM – Task Force's Response

- Application material to explain that:
 - One or a combination of the testing strategies can be selected in responding to the assessed RoMM
 - The risk factors will inform, instead of drive, the auditor's decisions about which testing strategy is selected.
 - The auditor's understanding of how management makes the accounting estimate should inform the auditor's decisions about which testing strategy is selected.
 - How the risk factors (complexity, judgment and estimation uncertainty) affect the auditor's work effort relating to data, assumptions and methods
 - That the higher the risk, the more persuasive the audit evidence needs to be, including highlighting the spectrum of risk

Responding to the assessed RoMM – Task Force's Response

- Controls Testing (Paragraph 16 ED-540)
 - Retain requirement
 - Highlight that, for significant risk, tests of controls need to be performed in the current period if the auditor plans to rely on controls
- Specialized Skills and Knowledge
 - To be discussed by Task Force – consider whether to merge the two requirements into one overarching requirement
- Significant Risk
 - Keep similar approach to ED-540 by focusing on spectrum of risk

Matter for IAASB Consideration

- 5) The IAASB is asked for its views on the proposed direction with respect to the response to the assessed risk of material misstatement, including the
- Testing strategies requirement, as set out in paragraphs 36-39
 - Control testing requirement as set out in paragraph 40
 - Work effort requirements as set out in paragraphs 41-45

Restructuring the Work Effort Requirements

- Task Force is of view that restructuring the work effort requirements could alleviate some of the concerns raised with respect to the clarity, readability, and operability
- Proposed structure is more closely aligned with how management makes and how auditor audits accounting estimates
 - Auditor will be required to select a testing strategy to respond to the ROMMs
 - For each testing strategy the TF will develop objectives-based requirements around data, assumptions and methods
 - Objectives-based requirements will vary to some extent depending on the strategy chosen
 - Application material explains how the risk factors affect the auditor's work effort relating to data, assumptions and methods

Matter for IAASB Consideration

- 6) The IAASB is asked for its views on the proposed restructuring of the main work effort requirements, including whether the proposed flow of these requirements will help to address concerns raised with respect to the clarity, readability, and operability of the standard

Conforming and Consequential Amendments to ISA 500 – What Did We Hear?

- Generally, respondents were supportive of the proposed intent of the changes and enhanced focus on the consideration of the relevance and reliability of information obtained from an External Information Source (EIS)
- A few respondents preferred to wait with making changes until the ISA 500 project can consider all potential changes in a more holistic manner
- Comments received primarily focused on three topics
 - Definition of EIS
 - Concern over the use of the term “publicly available” in the definition of EIS
 - Application material in support of the amended requirement in paragraph 7 of the standard
 - Linkage between proposed ISA 540 (Revised) and ISA 500
 - More direct link between ISA 540 (Revised) and ISA 500 to better draw attention to the important new guidance

Conforming and Consequential Amendments to ISA 500 – Task Force’s Response

- Given the overall broad support for the proposed changes, the Task Force believes it is in the public interest to make changes to ISA 500 as part of the revision of ISA 540
- Task Force’s initial thinking to address concerns raised:
 - Explore alternative words that can better convey what was intended by the words “publicly available” in the definition of an EIS. Support for the distinction between general and tailor-made data.
 - Consider whether some of the application material in ISA 500 should be included in ISA 540 (Revised)
 - Include more explicit linkage from ISA 540 (Revised) to the new application material in ISA 500 in respect of both information from an EIS and work of a management expert
- Changes to the application material will be considered in the re-drafting of ISA 500

Matter for IAASB Consideration

7) The IAASB is asked for its views on the proposed direction with respect to the conforming amendments to ISA 500, including:

- The Task Force's proposal to clarify the definition of an external information source to address concerns about the phrase "publicly available"
- The Task Force's proposal to draw attention in proposed ISA 540 (Revised) to the new material on external information sources in ISA 500

Next Steps

- Task Force will focus next on:
 - Analysis of question 1, 2, 5, 6, 8 and general comments
 - Analysis of application material
 - Re-drafted requirements of ISA 540 (Revised)
 - Discussions with certain respondents on proposed way forward
- Call with the IAASB CAG in December 2017
- At IAASB December 2017 meeting, the TF is aiming for a discussion of:
 - The analyses of the remaining questions to the ED and other issues arising from the comment letters
 - The redrafted requirements of the proposed final standard and an overview of proposed changes to the application material



IAASB

**International Auditing
and Assurance
Standards Board®**

www.iaasb.org

IAPN.

ISA.

ISAE.

ISQC.

ISRE.

ISRS.

For copyright, trademark, and permissions information, please go to [permissions](#) or contact permissions@ifac.org.
