

Draft ISA 540 (Revised)¹— Issues and Recommendations

1. Introduction and Overview of Agenda Item

Objective of Agenda Item

The objective of this agenda item is to consider the ISA 540 Task Force's (the Task Force) proposed revisions to selected paragraphs of draft ISA 540 (Revised).

1. **Agenda Item 1-A** includes certain paragraphs from proposed ISA 540 (Revised) that have been marked for changes from Agenda Item 2-C (Updated),² which was discussed by the Board on March 16, 2018. The Task Force has now taken into consideration all comments raised by Board members during the March 2018 IAASB meeting, and written comments received since then, and is proposing a number of further changes in response.
2. Given the limited time available on the teleconference, the Task Force is presenting for discussion only proposed changes to select introductory and requirements paragraphs, and certain related application material paragraphs. Other proposed changes to the draft of ISA 540 (Revised) will be presented at the June 2018 IAASB meeting. The Task Force used the following criteria in selecting the paragraphs presented in **Agenda Item 1-A**:
 - The number of comments received during the Friday session of the March 2018 IAASB meeting and subsequently in writing; and
 - The nature and extent of the changes that were made in response thereto.
3. The Task Force has presented only those application material paragraphs that are most directly relevant to the discussion of the proposed changes to the introductory and requirements paragraphs in **Agenda Item 1-A**. For example, because the principal proposed revision to paragraph 15 is in the last sentence, only the application material related to this sentence (paragraph A92E) has been presented.
4. Section 2 of this Agenda Item sets out the Task Force's request for input from the IAASB. Section 3 includes a discussion of the Task Force's rationale for the proposed changes to the presented paragraphs. The Appendix includes a list of recent Task Force activities.

Professional Skepticism

5. Task Force leadership deliberated further changes that could be made to proposed ISA 540 (Revised) to enhance the focus on, and importance of, the exercise of professional skepticism in auditing accounting estimates. Based on its initial discussion, and in line with the IAASB's discussion of professional skepticism at the March 2018 IAASB meeting,³ the Task Force is looking for opportunities to use words such as "challenge" or "question" in the application material to certain

¹ Draft ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

² www.iaasb.org/system/files/meetings/files/20180312-IAASB_Agenda_Item_2-C-UPDATED-ISA-540.pdf

³ See Agenda Item 9 at www.iaasb.org/meetings/amsterdam-netherlands.

requirements. The proposed changes will be discussed at the next Task Force meeting and will be presented for discussion at the June 2018 IAASB meeting.

2. Request for Input from IAASB

6. At this stage of the project, the Task Force is most in need of input on whether the Task Force has adequately responded to the comments made during the March 2018 IAASB meeting (and written comments received thereafter) with respect to the presented paragraphs. Many IAASB members provided written comments, and Staff has considered these in detail. Staff also is planning to reach out to those IAASB members who provided written comments to discuss the Task Force rationale for the changes made. This is in process and will be completed prior to the June 2018 IAASB meeting.
7. In light of the limited time available on the board teleconference, and the extensive comments received and responded to both during and after the March 2018 IAASB meeting, the Task Force requests that:
 - IAASB members focus their comments on the substance of the proposed changes.
 - Editorial comments on **Agenda Item 1-A** be provided to Staff offline no later than April 24, 2018 and be limited to the proposed changes.
8. Each IAASB member will be called on in turn, and will be asked to provide their comments on matters of substance in the whole of **Agenda Item 1-A**. There will be a second round of comments to allow members, if they wish, to reflect upon the comments made by other members.

3. Discussion of the Task Force's Rationale for the Proposed Changes

Introduction

9. The Task Force rationale for the principal proposed changes to the introductory paragraphs and related application material presented is as follows:
 - Paragraph 2A has been revised to respond to comments asking for greater clarity about the inherent risk factors and the measurement process.
 - Paragraph 3A has been revised to incorporate various editorial suggestions and to address concerns about the reference to a "continuous scale." The paragraph now indicates that the level of inherent risk varies on a scale from lower to higher, which is consistent with the wording in paragraphs A74A and A74B.
 - Paragraph 4 has been expanded to reference the separate assessment of control risk required by paragraph 13, and to acknowledge the references in proposed ISA 540 (Revised) to the importance of the consideration of internal control by the auditor when auditing accounting estimates. Paragraphs A1R and A1S were relocated to this section of the application material.
 - The key concept that the auditor's further audit procedures need to be responsive to the assessed risks of material misstatement at the assertion level, considering the reasons for the assessment given to those risks, has been moved into a separate paragraph 4A. This paragraph now also indicates that those reasons may relate to the effect of one or more inherent risk factors, or the auditor's assessment of control risk.
 - Paragraph 5 now includes a combined reference to susceptibility to management bias and susceptibility to misstatement due to fraud, to address comments raised during the Friday

session at the March 2018 IAASB meeting noting a preference for a direct reference to fraud. Corresponding proposed changes have been made to paragraph A1Q, which identifies other inherent risk factors, and in relevant places throughout the standard.

- The reference in paragraph 6 (second bullet) to “representative of the range” has been removed because that concept is more effectively described in application material paragraphs A41A and A41B in the context of the requirements of the applicable financial reporting framework.

Risk Assessment Procedures and Related Activities

10. The Task Force rationale for the principal proposed changes to paragraph 10 and related application material presented, is as follows:

- The introductory sentences were seen by some to imply, inappropriately, that the specific provisions in paragraph 10 might be optional. As this was not the Task Force’s intention, the sentence has been revised to align more closely with extant ISA 540, but to also use the construct “to the extent necessary” to reflect the inherent scalability. Paragraph A8A now includes some of the deleted text from paragraph 10 to further explain the inherent scalability. Further, the Task Force has included new guidance (paragraph A8AA) to make clear that the requirements in paragraph 10 of this ISA build on the broader requirements in ISA 315 (Revised)⁴ and relate more specifically to accounting estimates.
- Paragraph 10(h) on the entity’s risk assessment process has been amended to include a reference to inherent risk factors other than susceptibility to management bias. The Task Force believes it is clear that the focus of the requirement is for the auditor to look at the entity’s risk assessment process to see how it identifies and addresses risks with respect to the inherent risk factors, not a requirement for management to do so.
- Paragraph 10(i) has been restructured to better align with paragraphs 18(a) and (d) of extant ISA 315. This includes deleting the reference to “significant” estimates in the introduction, retaining the scoping language in 10(i)(i) about “classes of transactions, or other events and conditions, that are significant to the financial statements” (which mirrors the scoping language in paragraphs 18(a) and (d) of ISA 315), and linking the requirements in 10(i)(ii) to the accounting estimates addressed in 10(i)(i).
- The possible procedures to obtain an understanding that were included in paragraph A8A have been deleted. This is because some IAASB members noted that there was no parallel for this guidance for more challenging audits of accounting estimates. The Task Force considered including such guidance but concluded that it would not be helpful as the range of circumstances would be too broad to provide any useful guidance for more challenging audits of accounting estimates.

Identifying and Assessing the Risks of Material Misstatement

11. The Task Force rationale for the changes to paragraph 13 is as follows:

- The Task Force amended the introduction to address concerns that the way in which ‘shall’

⁴ ISA 315 (Revised), *Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment*

was used twice in the requirement could have unintended consequences for the complexity of the documentation of the auditor's risk assessments.

- The construct of paragraph 13(b) has been changed to align with the construct of the application material and to be consistent with other references throughout the standard to accounting estimates being “subject to, or affected by” the inherent risk factors.

Responses to the Assessed Risks of Material Misstatement

12. The Task Force rationale for the proposed changes to paragraphs 15 and A92E is as follows:

- The last sentence of paragraph 15 has been changed to incorporate the construct used in the last sentence of A92E, which some IAASB members thought was an effective “plain language” articulation of the intent of the sentence. Accordingly, the last sentence of paragraph A92E has been deleted.
- The introduction to paragraph 15 has been revised as it could be read, incorrectly, as suggesting that ISA 330⁵ requires the auditor to select one or more of the approaches included. The Task Force also added “and related disclosures about estimation uncertainty” to paragraph 15(b) to be consistent with the objective and paragraph 15(c), but was of the view that this addition was not needed in paragraph 15(a) because it may be less likely that there would be related disclosures about estimation uncertainty when events up to the date of the auditor's report provide audit evidence regarding the resolution of the estimation uncertainty with respect to the accounting estimate.

Developing an Auditor's Point Estimate or Range

13. The Task Force rationale for the proposed changes to paragraphs 18-18C and related application material is as follows:

- Paragraphs 18, 18A and 18B have been condensed into a single requirement, largely to address comments from some IAASB members that the intent of paragraph 18, structured as a standalone requirement, was not very clear. The Task Force agreed, noting that the focus should be on the requirement for the auditor to obtain sufficient appropriate audit evidence about the appropriateness of the methods, assumptions and data used. In that regard, paragraphs 18(a) and 18(b) retain the differentiation between when the auditor uses some or all of the auditor's own methods, assumptions or data compared to when the auditor is using management's methods, assumptions or data. The Task Force also plans to draft an application material paragraph to explain the intent of “as applicable” in paragraph 18(a) and will present this paragraph for discussion at the June IAASB meeting.
- The structure of paragraph 18C was changed to clarify that the focus of paragraph 18C(b) should be on determining whether sufficient appropriate audit evidence has been obtained about management's point estimate and related disclosures about estimation uncertainty. The determination of whether management's point estimate and related disclosures are reasonable is required by paragraph 23.
- An application material paragraph (A133) has been added to address questions about the auditor's range including “only amounts that are supported by sufficient appropriate audit

⁵ ISA 330, *The Auditor's Responses to Assessed Risks*

evidence.” The guidance is intended to clarify that the auditor is not expected to obtain separate audit evidence to support each possible outcome in the range.

Documentation

14. The Task Force rationale for the proposed changes to paragraph 27 and related application material is as follows:
- Paragraph 27(b)(i) has been revised to clarify that the documentation requirement applies to risks of material misstatement relating to accounting estimates for which inherent risk has been assessed at the higher end of the spectrum of inherent risk, including significant risks. This was done to address concerns from IAASB members that, as previously worded, the requirement would be overly burdensome for simpler accounting estimates and could result in a complicated matrix approach to the documentation. The Task Force believes that the revised wording better conveys the intent of the requirement, which is to evidence for higher assessed risks how the reasons for those assessed risks were considered in designing the further audit procedures.
 - Paragraph 27(b)(iii) has been revised to focus on the significant professional judgment in relation to indicators of management bias, that is, the auditor's evaluation of the implications for the audit when indicators of possible management bias are identified.

Matters for IAASB Consideration

The IAASB is asked for its views on the proposed changes to the selected paragraphs of proposed ISA 540 (Revised), as presented in **Agenda Item 1-A**.

Appendix

Task Force Activities Including Outreach and Coordination with Other IAASB Task Forces and Working Groups

1. The following sets out the recent activities of the Task Force, including outreach with others relating to the ISA 540 project.

Task Force Activities since the last IAASB Discussion

2. The Task Force's leadership and Staff held one physical meeting and the Task Force held one teleconference. The Task Force will meet during the week of April 23, 2018.

Outreach

3. The leadership of the Task Force held a teleconference with representatives of the International Forum of Independent Audit Regulators' Standards Coordination Working Group and met with staff of the US Public Company Accounting Oversight Board (PCAOB).