

ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures – Issues and Task Force’ Recommendations

Introduction

1. Since the November 2016 teleconference, the Task Force mainly focused on further developing the requirements relating to the auditor’s response to the risks of material misstatement (referred to as the “work effort requirements” in this paper) in accordance with ISA 330,¹ as well as certain other paragraphs in the requirements and introduction to ISA 540, as set out in paragraph 12 below. The Task Force also sought to improve the clarity, understandability, and conciseness of the draft proposed ISA.
2. The discussion at the December 2016 IAASB meeting will focus on the updated draft of ISA 540 (Revised) as shown in Agenda Item 2-B. This issues paper discusses the key changes from the drafts presented at the IAASB meeting in September 2016 and the November 2016 IAASB teleconference (as applicable).
3. The IAASB is asked to refer to Agenda Item 1 for the draft minutes of the discussion of ISA 540 at the November 2016 IAASB teleconference.

Structure of this Paper

4. This paper is organized as follows:
 - Section I: Responding to the Assessed Risks of Material Misstatement
 - Section II: Other Changes to ISA 540
 - Section III: Other Matters
 - Section IV: Next Steps

Matter for IAASB Consideration

1. At the beginning of the IAASB’s discussion, each member will be asked to highlight areas that they particularly wish to discuss in **Agenda Item 2-B**.

Section I – Responding to the Assessed Risks of Material Misstatements

Overview

5. The Task Force has continued to explore a number of options to improve the work effort requirements since the November 2016 teleconference. This included further discussion of different approaches to implementing a threshold for when the more detailed work effort requirements responsive to complexity, judgment or estimation uncertainty would be triggered.
6. The Task Force also considered different options and perspectives on how to articulate the role of inherent risk and control risk on the auditor’s assessment of, and response to, the risk of material

¹ ISA 330, The Auditor’s Responses to Assessed Risks

misstatement for accounting estimates, recognizing the IAASB's previous discussions on the topic in relation to ISA 540 in September 2016.

7. In doing so, a key aim for the Task Force was to draft requirements that are as simple and clear as possible. For example, the Task Force considered whether the drafting could be made simpler yet clear without a threshold for the more detailed requirements responsive to the three factors that give rise to the risk of material misstatement (complexity, judgment, and estimation uncertainty). The focus of the Task Force has been primarily on developing the requirements themselves, recognizing that the detailed drafting of the related application material remains to be done.

Main Changes Since September 2016 or November 2016 (as applicable)

8. The Task Force has made the following changes to the work effort requirements in Agenda Item 2-B:
 - (a) The Task Force overall has agreed to amend the order of the paragraphs to focus first on considering the need for specialized skills or knowledge in obtaining audit evidence, and then the work effort requirements, followed by other requirements addressing matters such as disclosures, and the “stand back” provision.
 - (b) **The overarching work effort requirement (see paragraph 13)** has been significantly redrafted to streamline and improve the flow of the requirement.
 - (i) Paragraph 13 now incorporates the basic requirements that apply to all assessed risks of material misstatement related to accounting estimates (formerly paragraph 13 and the introduction to paragraph 13A). Consistent with the discussion in the IAASB November 2016 teleconference, a threshold has been incorporated into the requirement and the threshold that has been used is “low.” Below this threshold, the auditor is not required to apply the more detailed requirements that apply above the threshold (now included in paragraphs 13A–13C), but is required to consider whether a procedure directed to the estimate overall would provide sufficient appropriate audit evidence concerning the identified and assessed risks of material misstatement at the assertion level. If not, the application material could guide the auditor to consider whether any of the procedures in paragraphs 13A–13C, together with such an overall procedure, could assist in doing so (see (iii) below)
 - (ii) The Task Force discussed a possible approach that would preclude the need for an explicit threshold in the requirement (the threshold would have addressed instead via the application material). On balance, the Task Force concluded that it would be preferable to have an explicit threshold in the requirements if this could be achieved in a manner that was appropriate and not complex. The Task Force believes that the proposed approach achieves this goal.
 - (iii) In response to the IAASB's feedback in the November 2016 teleconference, the Task Force considered how a threshold based on a low risk of material misstatement could be structured to facilitate the auditor's application of ISA 330 in designing and performing the nature, timing and extent of further audit procedures. ISA 330 establishes requirements for the auditor to respond to the risks of material misstatement at the assertion level through designing and performing substantive tests and tests of controls using professional judgment and in accordance with various more detailed considerations and requirements. The Task Force concluded that some of those

requirements and considerations should be triggered even when the combined assessment of the risk of material misstatement is low without regard to controls (as explained, for example in paragraph A10 of ISA 330). The Task Force therefore concluded that the threshold in the requirement should be when “the assessed risk of material misstatement is low without regard to relevant controls” (emphasis added) in paragraph 13(a). This is to allow the auditor to consider whether, for simpler estimates, a procedure directed to the estimate overall, such as substantive analytical procedures or subsequent cash receipts testing, can be performed to provide sufficient appropriate audit evidence regarding the assessed risk of material misstatement. This overall approach (instead of the more specific requirements in paragraphs 13A–13C) is only available when inherent risk is low. The application material provides references to key paragraphs in ISA 330 that describe the importance of the auditor’s consideration of inherent risk in designing and performing further audit procedures.

- (iv) When inherent risk is not low, the auditor must perform procedures in accordance with paragraphs 13A–13C, as applicable, to address the factors of complexity, judgment, and estimation uncertainty that drive the assessed risk of material misstatement. When the assessed risk of material misstatement is low based on an expectation that relevant controls are operating effectively, then the auditor’s response is required to include procedures to obtain audit evidence about the operating effectiveness of those controls (tests of controls). This emphasizes the existing requirements in paragraphs 7 and 8 of ISA 330.
- (v) The Task Force acknowledges that the reference to “without regard to relevant controls” in the threshold recognizes that the response is in effect a response to inherent risk. The Task Force also recognized that some may be concerned that this could be seen to depart from paragraph A40 of ISA 200² (that the assessment of risks of material misstatement at the assertion level may be performed through a separate or combined assessment of inherent and control risk) and ISA 330 (which requires the consideration of both inherent risk and control risk in designing and performing further audit procedures). It is not the intent of the Task Force to change the approach described in the application material to ISA 200, so the Task Force has drafted application material (see paragraph A58C) that explains this. The Task Force notes that how to apply the threshold when the auditor makes only a combined assessment of inherent and control risk may need further exploration.
- (vi) **The work effort requirements for assessed risks that are above the threshold (see paragraphs 13(b) and 13A-C)** have been redesigned to include a general requirement to perform procedures that address the reasons for the risk of material misstatement (paragraph 13(b)) and more detailed requirements (paragraphs 13A–13C) that apply respectively when those reasons include the three factors (complexity, judgment, and estimation uncertainty). The requirements in paragraphs 13A–13C focus on identifying appropriate objectives of the auditor in tailoring the nature of the response to the relevant factors.

² ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

- (vii) This “objectives-based” approach is intended to avoid the perception that only substantive procedures can or should be performed to address the reasons for the assessment given to the risk of material misstatement, when those reasons include the three factors. This approach also provides for differing circumstances and “future proofing” by requiring the auditor to determine the nature, timing and extent of further audit procedures, provided that such procedures appropriately address the factors driving the risk of material misstatement. This also avoids the need for an exception to the detailed requirements (previously in paragraph 13E of ISA 540 in the September 2016 draft) as the exception is no longer needed.
- (c) With respect to the **disclosures requirement (see paragraph 13D)**, the IAASB discussed the requirement and related application material in its November 2016 teleconference. The IAASB generally supported the revisions made, subject to their further review in light of more complete proposals for the work effort requirements, which were not included in the paper presented to the IAASB for the teleconference. Given the support of the IAASB, in principle, the Task Force did not make any significant revisions to the requirement and related application material as presented to the IAASB in November 2016. The changes made to the requirement either reflect further alignment with paragraph 13(b) of ISA 200 and paragraph 7(b) of ISA 700 (Revised)³ or changes to improve the clarity and readability of the standard. The Task Force also included additional bullets in paragraph A120 which are based on changes made as a result of the Disclosures project.
- (d) In its September 2016 meeting the IAASB was of the view that the **stand back requirement (see paragraph 13E)** should be mandatory for all accounting estimates, but that the stand back requirement should be more extensive for ‘more difficult accounting estimates.’ In this regard, the Task Force has added a requirement (13E(c)), to ensure that the auditor stands back to evaluate whether sufficient appropriate audit evidence was obtained in respect of the assessed risks of material misstatement when procedures were performed under paragraphs 13A-C (in other words, taking the view that the ‘more difficult accounting estimates’ are those for which procedures are triggered by these requirements). Further changes were made to streamline the requirements by incorporating requirements from extant ISA 540 addressing the following matters, as amended:
- Recognition, presentation, and disclosure (based on extant paragraph 17 and 19);
 - Management’s methods have appropriately applied the requirements of the applicable financial reporting framework (based on extant paragraph 12);
 - Whether the accounting estimates, individually or as a whole, are materially misstated in the context of the applicable financial reporting framework (based on extant paragraph 18);

The Task Force will further explore whether this requirement should be applied at the individual accounting estimate level, at the collective accounting estimate level, or both.

³ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Other Matters Related to the Work Effort

Significant Risks

9. In its November 2016 teleconference the IAASB discussed whether ISA 540 (Revised) should have specific additional procedures for accounting estimates that give rise to a significant risk. The IAASB was generally supportive of the Task Force's approach that such procedures were not deemed necessary due to the proposed revised structure of the work effort requirements, but noted that its view is dependent on the seeing the entirety of the work effort requirements, which were not presented to the IAASB for the teleconference.
10. The Task Force's view is that the work effort requirements, as presented to the IAASB in **Agenda Item 2-B**, have eliminated the need for different procedures for accounting estimates that give rise to significant risks. In view of this and given the IAASB's support, the Task Force did not include any specific additional procedures to respond to significant risks.

Matters for IAASB Consideration

2. The IAASB is asked for its views on paragraphs 11A-13E and the issues discussed above. The IAASB is also asked:
 - (a) Whether paragraph 13 is sufficiently clear on when the auditor is required to comply with paragraphs 13A–13C, including:
 - i. Whether the IAASB is satisfied with the Task Force's approach to the threshold in paragraph 13;
 - ii. Whether the IAASB supports the view that the approach to inherent risk in the threshold in paragraph 13 does not contradict the application material of ISA 200 that allows the auditor to do a combined assessment of inherent risk and control risk;
 - (b) Whether the IAASB supports the 'objectives-based' approach to the work effort in paragraphs 13A–13C, and what views the IAASB has on the level of detail to include in these paragraphs;
 - (c) Whether paragraphs 13A–13C are written in such a way to ensure that the auditor is designing and performing appropriate procedures that take into consideration the reasons for the assessment of the risk of material misstatement at the assertion level (i.e., the factors from paragraph 10 of Agenda Item 2-B); and
 - (d) Whether the stand back provision should address the accounting estimates collectively, each accounting estimate individually, or only those accounting for which procedures are triggered under paragraphs 13A–13C.

Section II – Other Changes to ISA 540

11. In addition to the work effort the Task Force also discussed the following matters since the September 2016 IAASB meeting:
 - Introduction – paragraphs 1-5
 - Objective – paragraph 6
 - Risk Assessment – paragraphs 8-10

- Indicators of Possible Management Bias – paragraph 21
- Written Representations – paragraph 22
- Communications with Those Charged with Governance – paragraph 22A
- Documentation – paragraph 23

Introduction

12. The Task Force discussed how the introduction section of ISA 540 could be enhanced given the changes made to the risk assessment and work effort sections and was of the view that introducing the three factors (complexity, judgment and estimation uncertainty) in the introduction would enhance the clarity and understandability of the standard. The Task Force therefore added application material that distinguishes the three factors from each other and explains possible sources from where risk may originate. These paragraphs are meant to explain these factors given the important role they play in the identification and assessment of the risk of material misstatement and the work effort.
13. The Task Force will continue its deliberations on the Introduction section to introduce and further clarify in this section the concepts of complexity, judgment and estimation uncertainty, and how they relate to the risk assessment and the work effort. In this way, readers of ISA 540 (Revised) will have an explanation of how the ISA is intended to operate at the beginning of the ISA to set the scene for the requirements. These paragraphs have not yet been drafted. The Task Force has begun to consider a number of drafting suggestions to accomplish this but have not yet had the opportunity to fully deliberate these and hence did not feel it appropriate to present these at this time.
14. The Task Force also discussed other enhancements in the introduction section and was of the view that paragraph 4A could be seen as duplicative given that paragraph 1 states that ISA 540 deals with accounting estimates and paragraph 13(a) explains that, for accounting estimates with a low risk of material misstatement, paragraph 13A-C do not apply. The Task Force therefore decided to take out paragraph 4A. Paragraph 3 was deleted also as it largely dealt with fair value accounting estimates and needs to be drafted in a revised format that is more inclusive of other measurement bases.
15. The discussions in the Task Force also highlighted that some changes to the application material could be made to enhance the standard. These changes include:
 - *Introducing and explaining what is meant by reasonable.* The IAASB discussed proposed changes to the objective in its November 2016 teleconference and suggested to explain the term 'reasonable' in the application material. The term 'reasonable' is used in the objective of ISA 540 and throughout the standard in relation to the assumptions, range of outcomes, and in the context of the financial reporting framework. The Task Force discussed the IAASB's responses to the objective section and decided, given the views of the IAASB, to defer making any changes to this section until the requirements related to the work effort are completed. The Task Force was of the view that drafting the new objective would benefit from having the detailed work effort finalized, from which it could then be based off. The objective shown in **Agenda Item 2-B** is therefore similar to the version presented to the IAASB in September 2016. Based on the IAASB's suggestion the Task Force will consider alternatives to address the use of the term 'reasonable' and 'adequate' which are used in paragraph 6(a) and 6(b) respectively.

- *Reallocating paragraph A2 and A3 to the application material related to paragraph 10.* Paragraph A2 and A3 provide, respectively, examples of accounting estimates that may give rise to a low risk of material misstatement and accounting estimates that may give rise to a risk of material misstatement that is not low. The Task Force was of the view that these paragraphs could be better placed under paragraph 10 as that paragraph requires the auditor to identify and assess the risk of material misstatement in relation to accounting estimates. These paragraphs could guide the auditor in the assessment of the risk of material misstatement. They also intend to signal the scalability of the standard by highlighting that certain accounting estimates may have a low risk of material misstatement without regard to relevant controls and are therefore excluded from the work effort requirements in paragraph 13A–C.
- *Reordering the other application material.* The Task Force reordered the application material given the changes made to the introduction section and to improve the readability of the application material in some other areas where other changes were made to the requirements. The Task Force will consider further changes to the application material given the continued deliberations over the Introduction section as highlighted by paragraph 42.

Risk Assessment

16. The Task Force made some limited changes to the risk assessment paragraphs (paragraph 8-10) to improve the clarity, understandability and conciseness of the standard, and to address comments received from the IAASB and IAASB Consultative Advisory Group.
17. With respect to paragraph 8, the IAASB noted in its September 2016 meeting that listing each of the five components of internal control, could be seen as duplicative as it repeats ISA 315 (Revised).⁴ The Task Force therefore decided to make reference to the five components in more general terms. The Task Force was of the view that the requirement to obtain an understanding of the components of internal control could best be included as a separate bullet under paragraph 8 (paragraph 8(d)).
18. The changes made to the requirement in paragraph 9A, which requires the auditor to assess whether specialized skills or knowledge are required in order to perform the risk assessment procedures, are intended to more closely align the requirement in that paragraph with the requirement in paragraph 11A which requires the auditor to assess whether specialized skills or knowledge are required in order to obtain sufficient appropriate audit evidence.
19. The Task Force made changes to paragraph 10 as, in describing the difference between the three factors (complexity, judgment and estimation uncertainty) in the introduction section of ISA 540, the Task Force noted that some changes could be made to requirement 10 and the related application material to improve the clarity and understandability of the standard. The discussions on the introduction section also highlighted that the difference between the factors could be emphasized more precisely in the requirement and application material related to paragraph 10. In addition some paragraphs in the application material were taken out as they had overlap with the new application material that was added to paragraph 2. Some further amendments to the application material may be necessary as the Task Force finalizes other aspects of the ISA.

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

20. The changes to paragraph 10 are meant to clarify the different factors and make this section more concise but do not constitute a significant departure from what was shown to the IAASB in its September meeting.

Indicators of Possible Management Bias

21. With respect to indicators of possible management bias, the Task Force made changes to paragraph 21 of proposed draft ISA 540 (Revised) to highlight that individual judgments or decisions may seem reasonable, but when viewed holistically may indicate bias.
22. Given the possibility of fraud in making judgments or assumptions related to significant accounting estimates, the Task Force included a reference to fraud in the requirement thereby acknowledging the requirement that exists in paragraph 32(b) in ISA 240.⁵ The related application material includes indicators of possible management bias related to accounting estimates.

Written Representations

23. The Task Force discussed paragraph 22 of proposed draft ISA 540 (Revised) and related application material with respect to written representations. The Task Force was of the view that the requirement should be broadened to address “methods” and “data” rather than only assumptions, recognizing that the selection of the method and data are also items that the auditor shall obtain representations on. In the requirement a reference is added to ‘related disclosures’ to emphasize the importance of including disclosures in the written representations with respect to accounting estimates.
24. Compared to the version of ISA 540 presented to the IAASB in its September 2016 meeting, the Task Force reinstated the term “significant” in the requirement and deleted “key.” The former is used in ISA 701⁶ in the context of management’s judgments relating to accounting estimates and the Task Force considered it appropriate here in the context of written representations.
25. In the application material, the Task Force extended the list of matters that the auditor may consider including in the written representations. The Task Force also considered conforming amendments to ISA 580⁷ – see **Agenda Item 2-D**.

Communication with Those Charged with Governance

26. The Task Force discussed paragraph 22A of proposed draft ISA 540 (Revised), related application material and possible conforming amendments to ISA 260 (Revised)⁸ (see **Agenda Item 2-D**) with respect to the communication with those charged with governance and made several changes to the requirement and related application material.
27. For the lead-in, the Task Force adopted the same construct as used in paragraphs 8, 10 and 13, by referring back to the requirement that already exists in ISA 260 (Revised) (paragraph 16(a)). This emphasizes that this is not a new requirement, but is instead additional clarification on how it is to be applied in the context of accounting estimates. The requirement also includes a link back to the

⁵ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

⁶ ISA 701, *Communicating Key Audit Matters in the Independent Auditor’s Report*

⁷ ISA 580, *Written Representations*

⁸ ISA 260 (Revised), *Communication with Those Charged with Governance*

consideration of factors complexity, judgment and estimation uncertainty given the importance of these factors in ISA 540 (Revised).

28. The Task Force retained the application material relating to communication with regulators despite concerns from a few IAASB members about the inclusion of such application material. The Task Force was of the view that this application material is particularly important to certain key stakeholders, such as banking and insurance regulators, that it would be useful to keep. The Task Force also noted that a possible future International Auditing Practice Note on the communication between the auditor and financial institution regulators could highlight how this paragraph could be applied in those circumstances.

Documentation

29. In the IAASB's September 2016 meeting, the IAASB made several suggestions especially related to the requirement to document (i) the rationale for the auditor's judgment to use, or not to use, an auditor's expert for every accounting estimate with high estimation uncertainty, high judgment or high complexity, (ii) the basis for how the auditor demonstrated professional skepticism, and (iii) other procedures that are more responsive to the risk of material misstatement.
30. The Task Force agreed with the view expressed by some IAASB members that the requirement to document whether to use, or not to use, an auditor's expert for every accounting estimate with high estimation uncertainty, high judgment or high complexity would be overly burdensome as some may interpret the paragraph as requiring the auditor to engage an auditor's expert for every such accounting estimate.
31. With respect to the requirement to document how the auditor demonstrated professional skepticism, the Task Force decided, after liaison with the Chair of the Professional Skepticism Working Group, that a documentation requirement in ISA 540 would not be appropriate, as the Professional Skepticism Working Group may make recommendations about a broader requirement in due course. The Task Force has therefore reverted back to extant ISA 540 to document the basis for the auditor's conclusions about the reasonableness of the accounting estimate and the related disclosures (excluding reference to significant risks, as the requirement is now applied to all estimates). In addition, the requirement to document indicators of possible management bias, if any, has been expanded to also address the auditor's evaluation thereon, as it was noted that simply requiring documentation of any indicators, but not how the auditor dealt with them, was insufficient.

Matter for IAASB Consideration

3. The IAASB is asked for its views on the issues discussed in Section II above.

Section III: Other Matters

Professional Skepticism

32. At the June 2016 IAASB meeting, the IAASB members of the Professional Skepticism Working Group (PSWG-IAASB) made a series of recommendations to the Task Force on how to address professional skepticism in the revision of ISA 540.⁹

⁹ www.iaasb.org/meetings/new-york-usa-13

33. There has been a continued focus on professional skepticism throughout the Task Force discussions, and the PSWG-IAASB's paper was valuable input into this process. Some matters were already under discussion at the time, such as (i) the consideration of how the ISA 540 risk assessment relates to the ISA 315 risk assessment; and (ii) inclusion of a "stand-back" provision to draw together the audit evidence obtained in relation to accounting estimates to enable the auditor to draw overall conclusions.
34. Although the Task Force has not fully discussed the specific PSWG-IAASB recommendations, the Task Force believes that changes in wording can and should result in a difference in the auditor's obligations. That is, a phrase such as "the auditor shall challenge/question/evaluate/consider management's [assumptions, for example]" should clearly signal and result in different work and different documentation depending on the verb used.
35. The recommendations concerning the risk assessment procedures have been considered but more can be done. The Task Force has reinforced the concept of "what can go wrong" by expanding the focus of ISA 540 from estimation uncertainty alone to the factors of complexity, judgment and estimation uncertainty that give rise to risks of material misstatement related to accounting estimates.
36. The Task Force has reinforced the focus on controls in relation to ISA 540 in the risk assessment section and has discussed the implications for the work effort sections (see Section I of this paper), particularly due to the comments from the outreach conducted that this was important to current practice in the auditing of accounting estimates.

Exploration of Whether to Specifically Address the Testing of the Operating Effectiveness of Controls

37. During the outreach and Task Force discussions, both banking and insurance regulators have noted that an audit of financial statements for a bank or insurer should involve testing the operating effectiveness of relevant controls over how management made the accounting estimate. This is because, as large entities with a high number of accounting estimates and a high volume of transactions in financial instruments, it is difficult to see how a purely substantive approach could result in the auditor obtaining sufficient appropriate audit evidence.
38. Although the Task Force has sought to introduce a greater focus on identifying and testing the operating effectiveness of controls, there continues to be a view that a specific requirement is needed in ISA 540 to address circumstances when the auditor should test controls, in addition to the existing requirements in ISA 330.
39. In addition to obtaining and understanding of internal control relevant to the audit and the control environment (see paragraphs 12–14 of ISA 315 (Revised)), paragraph 8 of ISA 330 states:

"The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

 - (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
 - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)"

This is in addition to the requirement to obtain an understanding of internal control relevant to the audit and the control environment (see paragraphs 12–14 of ISA 315 (Revised)).

40. Two options are covered below that have been explored by the Task Force. These options are not intended to signal final drafting or proposals, but some drafting has been attempted to illustrate to the IAASB the implications of the approaches.
41. In view of the above, the Task Force has explored the two options shown below.
 - (a) Option 1 is an additional requirement for ISA 540. This approach has the merit of driving a higher expectation on the importance of testing controls. However, it could be viewed by some as redundant given the requirement in paragraph 8(b) of ISA 330.
 - (b) Option 2 is intended to achieve the same objective as Option 1, but consists only of amendments to the application material to ISA 330.

The wording shown below is preliminary drafting to allow the IAASB to better understand the implications of the approaches.

42. Another option considered by the Task Force was mandating testing the operating effectiveness of controls when the audited entity is a bank or insurer. This approach may be seen as driving a stronger and clearer requirement for such entities (and would therefore be responsive to the calls from regulators of such entities), but may lead to questions as to why such entities are being singled out (as opposed to other entities with similar characteristics such as telecommunication companies, or indeed large companies in any industry). The Task Force rejected this approach on the basis that it would be difficult to identify consistently what is a bank or insurer (or banking activities and insurance activities), that requiring tests of controls may go beyond the scope of an audit of financial statements, and that it prejudices the audit approach that the auditor should take.

Option 1 –Requirement in ISA 540 to expand on when substantive procedures alone cannot provide sufficient appropriate audit evidence

X1. In applying ISA 330, the auditor shall determine whether the nature of the entity's process to make the accounting estimate is such that substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. In this case, the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. (Ref: Para. AX1)

Application Material For Option 1A

AX1. Some entities, such as large banks, insurers, telecommunication entities, and other entities make extensive use of IT to conduct their business or have a high number of accounting estimates, many of which are judgmental or complex, in their financial reports,. For audits of these entities is not likely to be possible or practicable to design effective substantive procedures that, by themselves, provide sufficient appropriate audit evidence at the assertion level. ISA 330¹⁰ contains requirements and guidance on when the auditor is required to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls. In some jurisdictions, as part of the audit of the financial

¹⁰ ISA 330, paragraph 8

statements for certain entities (such as a bank or insurers), the auditor may also be required by law or regulation to undertake additional work to provide assurance on internal controls.

Option 2 – Conforming amendment to ISA 330

[Note: shown with marked changes from extant ISA 330]

Tests of Controls

[Note: no changes to paragraph 8 of ISA 330]

8. The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:
- (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or
 - (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20–A24)

* * *

A24. In some cases, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level.¹¹ This may occur when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system. In such cases, paragraph 8(b) requires the auditor to perform tests of relevant controls. Factors that may indicate that substantive procedures alone may not be able to provide sufficient appropriate audit evidence at the assertion level include:

- The extent to which an entity conducts its business using IT;
- The volume of transactions (for example, a high volume of transactions may occur in a large bank or telecommunication entity making it more difficult to design substantive procedures that may alone provide sufficient appropriate audit evidence at the assertion level);
- A high volume of accounting estimates requiring a significant degree of judgment or complexity;
- Whether significant information supporting one or more relevant assertions is electronically initiated, recorded, processed, or reported. For such assertions, significant audit evidence may be available only in electronic form. In such cases, the sufficiency and appropriateness of the audit evidence may depend on the effectiveness of controls over their accuracy and completeness, and the potential for improper initiation or alteration of information to occur and not be detected may be greater if information is initiated, recorded, processed, or reported only in electronic form and appropriate controls are not operating effectively

¹¹ ISA 315 (Revised), paragraph 30

When substantive procedures alone cannot provide sufficient appropriate audit evidence, paragraph 8(b) requires the auditor to perform tests of relevant controls.

Matter for IAASB Consideration

4. What views does the IAASB have the on the Task Force's exploration of this issue, including the two options? Which option (if any) is preferred?

Section IV: Next Steps

43. The Task Force notes that there are matters that have not yet been addressed, or that require a further discussion at the Task Force level. These include:
- The application material supporting the work effort, including repurposing or revising application material that related specifically to the extant ISA 540 work effort requirements.
 - An explanation in the introductory paragraphs of the ISA of the purpose and intended operation of ISA 540.
 - Whether and how to incorporate material addressing illiquid or inactive markets, based on relevant material from IAPN 1000.¹²
 - Certain specific recommendations of the PSWG that have not yet been addressed.

¹² International Auditing Practice Note (IAPN) 1000, Special Considerations in Auditing Financial Instruments