

Analysis of Responses to Question 3 of the Exposure Draft

Section I: Question included in Exposure Draft

- The following question was asked in the exposure draft:

Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?

Section II: Staff Analysis of Respondents' Views¹

- Scalability is a broad topic and affects many aspects of proposed ISA 540 (Revised). The Task Force and staff will continue to analyze the comment letters received regarding perspectives related to scalability, and will bring analysis on, and proposed responses to, other points on scalability throughout the finalization of the ISA. Depending on how the Board chooses deal with scalability in ISA 540, the Task Force will undertake further analysis on selected issues contained in this document.

Overall Comments About Scalability, Including When There is Low Inherent Risk

- Many respondents supported ED-540's approach to scalability, including when there is low inherent risk.² Reasons for support included that:
 - The threshold of low/not low inherent risk is a practical approach to scalability;
 - The proposed approach for low inherent risks is not substantially different to extant ISA 540; and
 - Allowing flexibility with respect to low inherent risk estimates and greater prescription for higher risk estimates balanced the need for consistent application with appropriate levels of audit procedures.

A further analysis of the comments on the threshold of low/not low inherent risk is below in paragraphs 16–19.

- By contrast, many respondents expressed concerns about the scalability of ED-540 or the manner in which it was achieved.³ Many other respondents either did not respond explicitly to the question, or

¹ In this paper the following terms have been used:

- "A respondent" = 1;
- "A few" = 2–3;
- "Some" = 4–6;
- "Several" = 7–11;
- "Many" = 12–34;
- "Majority" = more than 50%; and
- "Significant majority" = greater than ~80%.

² *Investors & Analysts: CFA, Regulators: IAIS, UKFRC, NSS: HKICPA, MAASB, Firms: EYG, PKF, RSM, SRA, Public Sector Organizations: CIPFA, Member Bodies and Other Professional Organizations: AE, CAI, FACPCE, IAAA, IBRACON, ICAG, ICASL, ICAZ, ICPAK, KICPA, SAICA, Individuals and Others: Cygnus Atratus*

³ *Regulators: IOSCO, NSS: AUASB, CAASB, CNCC-CSOEC, IDW, JICPA, NZAUASB, Firms: BDO, DTT, KPMG, PWC, Public Sector Organizations: ACAG, AGA, AGC, AGNZ, INTOSAI, PAS Member Bodies and Other Professional Organizations: ACCA-CAANZ, AICPA, ANAN, CPAA, IBR-IRE, ICAEW, ICAP, SMPC*

their response was sufficiently nuanced or mixed to make it difficult to assess their overall views regarding the scalability of proposed ISA 540 (Revised).⁴

5. A few respondents thought the standard was too complex or confusing to be scalable⁵ while another thought it implied a checklist approach.⁶ A respondent did not believe that most of the standard addressed scalability⁷ while several respondents requested additional application material to improve scalability.⁸

Monitoring Group Responses

6. One Monitoring Group member⁹ specifically supported the scalability of ED-540, but noted that their focus was on higher inherent risks.
7. Monitoring Group respondents¹⁰ made comments related to the scalability of the ISA, specifically:
 - Opposing the use of a threshold to distinguish different levels of work effort as it may result in auditors inappropriately assessing risks as low to avoid the more detailed work effort requirements for not low inherent risks;¹¹
 - Asking that the Board clarify whether an estimate can only be assessed as low when none of the risk factors are present, and that the ISA should require documentation of the assessment of risks as low inherent risk;¹²
 - Suggesting that there should be a single set of testing objectives that apply to all estimates, regardless of whether inherent risk is low or not;¹³
 - Emphasizing the importance of aligning proposed ISA 315 (Revised) to ensure a proper understanding of new concepts such as low/not low inherent risk.¹⁴
 - Two Monitoring Group respondents supported the focus on inherent risks.¹⁵ One respondent believed that the concepts of low/not low inherent risk need to be better explained,¹⁶ but both expressed concern about challenges in execution or inconsistent audit approaches, due to the potential for differing responses in terms of work effort;

⁴ *Investors and Analysts:* CRUF, *Those Charged With Governance:* AICD, *Regulators and Oversight Authorities:* BCBS, NSSs: NBA, *Firms:* CHI, GTI, *Public Sector Organizations:* GAO, PAS, *Preparers of Financial Statements:* ABA, *Member Bodies and Other Professional Organizations:* CAQ, EFAA, IAA, ICAS, ISCA, NASBA, *Academics:* GC, *Individuals and Others:* MANTRI, NDEG

⁵ *NSS:* CNCC-CSOEC, *Firms:* RSM

⁶ *Firms:* GTI

⁷ *NSS:* AUASB

⁸ *NSS:* CNCC-CSOEC, HKICPA, *Firms:* EYG, KPMG, PWC, *Member Bodies and Other Professional Organizations:* EFAA, ICASL, SAICA, *Individuals and Others:* NDEG

⁹ *Regulators:* IAIS

¹⁰ *Regulators:* BCBS, IAIS, IFIAR, IOSCO

¹¹ *Regulators:* IOSCO

¹² *Regulators:* IFIAR

¹³ *Regulators:* IOSCO

¹⁴ *Regulators:* IFIAR

¹⁵ *Regulators:* IFIAR, IOSCO

¹⁶ *Regulators:* IOSCO

- A suggestion to focus on the audit of financial institutions given the importance of complex accounting estimates in the audit of, for example, insurance contract liabilities¹⁷ and expected credit loss provisions.¹⁸ A Monitoring Group respondent noted that there should be specific guidance on other complex estimates such as financial instrument valuations, impairments, and tax balances.¹⁹
- Noting the importance of understanding internal controls for audits of most accounting estimates;²⁰
- Expanding the material addressing model complexity;²¹

“Simple”/Low Inherent Risk Estimates²²

8. A few respondents suggested that the standard was too complex or confusing for “simple” estimates.²³ A respondent thought the work effort required for “quantitatively trivial” estimates was too much.²⁴
9. Many respondents had concerns that the risk assessment requirements were not scalable for “simple” estimates.²⁵ Some respondents specifically highlighted that the requirements regarding obtaining an understanding of internal control were excessive for “simple” estimates.²⁶
10. Some respondents noted that more application material was needed for simple estimates.²⁷
11. A few respondents believed that application of the risk factors approach would lead to all but the simplest estimates giving rise to “not low” inherent risk.²⁸ A few others were unsure about what the required response would be when the risk is low but the amount is material.²⁹ One respondent believes that changes in financial reporting mean too many estimates will be not low, reducing the utility of the threshold and resulting in disproportionate work required for some estimates on the lower end of the risk scale.³⁰
12. A respondent flagged that there may be confusion between what is meant by low by those that use a rating scale for risks that includes “moderate” or similar. This respondent believes that the threshold should be at the higher end of complexity, judgment, or estimation uncertainty.³¹

¹⁷ *Regulators:* IAIS, IOSCO

¹⁸ *Regulators:* BCBS, IOSCO

¹⁹ IOSCO

²⁰ BCBS

²¹ BCBS

²² Respondents referred variously to simple, low risk, or low inherent risk estimates. These have all been grouped under the heading “simple” estimates.

²³ *NSS:* IDW, *Firms:* DTT, KPMG

²⁴ *NSS:* JICPA

²⁵ *NSS:* CAASB, IDW, JICPA, *Firms:* BDO, KPMG, *Public Sector Organizations:* AGNZ, *Member Bodies and Other Professional Organizations:* AE, CAQ, EFAA, IBR-IRE, ICAEW, ICAS, SAICA, SMPC

²⁶ *NSS:* CAASB, CNCC-CSOEC, *Firms:* PKF, RSM, *Public Sector Organizations:* INTOSAI, *Member Bodies and Other Professional Organizations:* AE, ICAEW, SAICA, SMPC

²⁷ *NSS:* CNCC-CSOEC, HKICPA, *Firms:* KPMG, *Member Bodies and Other Professional Organizations:* EFAA, SAICA, *Individuals and Others:* NDEG

²⁸ *NSS:* AUASB, *Member Bodies and Other Professional Organizations:* CPAA

²⁹ *Regulators:* IRBA, *Firms:* GTI

³⁰ *Member Bodies and Other Professional Organizations:* AE

³¹ *Member Bodies and Other Professional Organizations:* SMPC

13. Some respondents also commented that the concept of a spectrum of risk should be emphasized, often because it would support scalability.³²

Comments on Application to SME Audits

14. Some respondents thought the proposals were impractical or unworkable for mid-tier/smaller practitioners or those not in the financial sector.³³
15. Some thought more AM was needed on SME issues,³⁴ while others thought the proposed application material for SMEs was not appropriate, particularly because small entities can have complex accounting estimates.³⁵

Behavioral Implications of Proposals

16. A few respondents noted that auditors may inappropriately assess risks as low to avoid work effort.³⁶ The examples in paragraphs A72 and A73 were seen by one respondent to be helpful in avoiding this³⁷ but another respondent thinks that the examples negate the auditor's judgment.³⁸ Another respondent wanted more detail included in paragraph A72 to aid SME auditors.³⁹

Implications of the Threshold of Low/Not Low Inherent Risks

17. While some were opposed to the threshold,⁴⁰ several others thought it needed to be clarified.⁴¹ One respondent suggested that better explanation of the risk factors could avoid the need for the threshold.⁴² These comments and concerns need to be read in the context of the supportive comments on the scalability of the ISA as a whole shown in paragraph 1.
18. A few believe that the focus on threshold detracts from the auditor's focus on doing appropriate work on each risk.⁴³
19. Some respondents wanted scalability to be introduced for higher risk estimates.⁴⁴ One suggestion on how to do this is to incorporate elements on paragraph 26(d) of the Explanatory Memorandum into ISA 540.⁴⁵

³² NSS: NZAUASB, Firms: DTT, Member Bodies and Other Professional Organizations: ACCA-CAANZ, PWC, Individuals and Others: NDEG

³³ NSS: AUASB, Firms: RSM, Member Bodies and Other Professional Organizations: ACCA-CAANZ, SMPC

³⁴ NSS: NBA, Member Bodies and Other Professional Organizations: AE, EFAA, ICAEW, SMPC

³⁵ Firms: DTT, EYG

³⁶ Regulators: IOSCO, UKFRC, Member Bodies and Other Professional Organizations: ICAEW

³⁷ Regulators: UKFRC

³⁸ Firms: DTT

³⁹ Member Bodies and Other Professional Organizations: AE

⁴⁰ Firms: KPMG, PWC, Public Sector Organizations: AGNZ, Member Bodies and Other Professional Organizations: AICPA, IBRACON

⁴¹ Regulators: IFIAR, NSS: NZAUASB, Firms: DTT, Public Sector Organizations: AGA, Member Bodies and Other Professional Organizations: ICAZ, SMPC, Individuals and Others: Cygnus Atratus, NDEG

⁴² Member Bodies and Other Professional Organizations: ICPAK

⁴³ Firms: GTI, Member Bodies and Other Professional Organizations: AICPA, IBRACON

⁴⁴ Regulators: ESMA, NSS: NBA, Firms: KPMG, Member Bodies and Other Professional Organizations: ICAEW, Individuals and Others: NDEG

⁴⁵ Firms: GTI

20. Respondents also commented on the implications of the threshold for the auditor's work effort. Please refer also to Agenda Item 2-C for further analysis of related issues. Comments on this topic from the perspective of scalability include:
- a) The work effort on low inherent risk (IR) is excessive;⁴⁶
 - b) It was seen as unclear how the work effort for low IR related to the not low work effort;⁴⁷
 - c) Subsequent events testing may be particularly useful for some low risk estimates,⁴⁸ and that if the outcome is known at the date of the report, then the required understanding in paragraph 10 should be minimal;⁴⁹ and
 - d) A few respondents had the perception that that the procedures in paragraphs 15(a)-(c) could not be used to help meet the objectives in paragraphs 17-19.⁵⁰

Conceptual Issues

21. Several respondents highlighted unintended consequences or confusion arising from introducing the concepts of low / not low inherent risk, and how these operate with concepts in other ISAs and sought clarification.⁵¹ Concepts that these respondents found difficult to reconcile with the ED-540 approach included ISA 315 and ISA 330 concepts, particularly significant risks, and the concept of materiality
22. Other conceptual issues included a few respondents who were opposed to requiring a separate assessment of IR.⁵² Another respondent saw challenges in requiring a separate assessment, including whether a separate or combined assessment would lead to a different response in terms of work effort;⁵³

Other Comments Related to Scalability

23. The flowchart was seen to be helpful to several respondents as a supplement to the ISA or for inclusion in the ISA as it showed how the ISA could be applied in a scalable way.⁵⁴
24. A few respondents thought that documentation would increase for both low and not low risks.⁵⁵ Another respondent suggested that documentation be required for the auditor's assessment of a risk as low inherent risk.⁵⁶

⁴⁶ Firms: BDO, PWC, NSS: JICPA Member Bodies and Other Professional Organizations: CAQ, ICAP,

⁴⁷ Firms: EYG, GTI, Member Bodies and Other Professional Organizations: SMPC

⁴⁸ Member Bodies and Other Professional Organizations: IBRACON, Individuals and Others: NDEG

⁴⁹ Firms: KPMG, PWC

⁵⁰ Public Sector Organizations: GAO, Member Bodies and Other Professional Organizations: EFAA, IBRACON

⁵¹ Regulators: CEAOB, Firms: BDO, GTI, KPMG, Public Sector Organizations: AGNZ, Member Bodies and Other Professional Organizations: AE, AICPA, CPAA, ICAEW, ICAP, ICAS, ISCA

⁵² NSS: AUASB, Firms: KPMG, Member Bodies and Other Professional Organizations: AICPA

⁵³ Regulators: **IFIAR**

⁵⁴ Regulators: **BCBS**, NSS: AUASB, CAASB, NBA, NZAUASB, Firms: RSM, Member Bodies and Other Professional Organizations: AE, EFAA, ICAEW, SMPC

⁵⁵ Member Bodies and Other Professional Organizations: SAICA, SMPC

⁵⁶ Regulators: **IFIAR**