

Proposed ISA 540 (Revised)¹—Issues and Recommendations

Objectives of Agenda Item

The objectives of this agenda item are:

1. To consider the Task Force proposed revisions to draft ISA 540 (Revised).
2. To provide the Task Force with direction on certain key issues raised by respondents.

1. Introduction and Overview of Agenda Items

1. Since the October 2017 IAASB meeting, the Task Force has focused on redrafting the requirements and analyzing and responding to comments on the application material. In this process, and as part of the continuing analysis of the comment letters received on the Exposure Draft of proposed ISA-540 (Revised) (ED-540), the Task Force has identified certain key issues raised by respondents for which it is seeking input from the IAASB. These issues are:
 - Scalability (See Section 2);
 - Use of the term “reasonable” (See Section 3);
 - Professional skepticism (See Section 4);
 - Application material (See Section 5); and
 - Conforming and Consequential Amendments (See Section 6).
2. The Task Force has developed a series of additional papers to support the discussion in December. These papers are as follows:
 - Agenda Item 2-A: A discussion of significant issues that the Task Force identified in considering the comments on the requirements and the consequential and conforming amendments, and the Task Force’s responses thereto;
 - Agenda Item 2-B: Proposed ISA 540 (Revised) – Marked;
 - Agenda Item 2-C: Proposed ISA 540 (Revised) – Clean;
 - Agenda Item 2-D: Proposed Consequential and Conforming Amendments;
 - Agenda Item 2-E.1: Summary of Categories of Themes;
 - Agenda Item 2-E.2: Inventory of Changes to Application Material in ED-540; and
 - Agenda Item 2-F: Analysis of Questions 1, 2, 5, 6, 8, from ED-540 and General Comments.

In addition to these Agenda Items, the Task Force has also prepared supplementary material **for reference only**, which is explained further in Section 5.

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

2. Scalability

2.1 Background

3. At the October 2017 IAASB meeting, the Task Force discussed with the IAASB the preliminary analysis of the comments received on question 3 of ED-540, which asked for respondents' views on the scalability of the proposed standard, including when there is low inherent risk. See **Agenda Item 2-B** from the October 2017 IAASB meeting.
4. Based on the preliminary analysis of comments, the Task Force noted that respondents supported the IAASB's decision to attempt to specifically address scalability in ED-540, but expressed concerns that the mechanism of the threshold of low/not low inherent risk added to the overall complexity of the standard. The Task Force considered whether the threshold should be clarified, or whether it should be removed and replaced with an alternative approach to support scalability.
5. The Task Force believed that removing the threshold could address the concerns of respondents about complexity and relationship to other ISAs (in particular ISA 315 (Revised))², while also being responsive to other comments requesting further guidance to make the threshold more operable in practice. However, removing the threshold would mean that the desired scalability in the auditor's work effort for all accounting estimates needs to be clearly demonstrated or described in other ways.
6. The IAASB agreed that the Task Force should continue to explore removing the threshold, while keeping scalability, simplicity, and practicality at the forefront of the development of the revised requirements. The IAASB also agreed that the revised ISA should reinforce the spectrum of risk concept, drawing upon existing material in ISA 315 (Revised) and ISA 330³ in this respect, and demonstrate how this concept could help drive scalability of the standard in practice.
7. The Task Force also agreed to do a further review and analysis of the comment letters before finalizing the analysis regarding respondents' views on scalability. This further analysis is in progress and will be completed prior to the December 2017 IAASB meeting.

2.2 Task Force Discussion and Response

8. The Task Force continues to recognize the importance of making sure that ISA 540 (Revised) is viewed to be scalable in its application for all types of accounting estimates. This recognizes that respondents to ED-540 commented on the need for a proportionate work effort for lower risk (i.e., "simple") accounting estimates as well as higher risk estimates (e.g., provisions for expected credit losses).
9. In the course of its discussions, the Task Force considered that scalability could be introduced and demonstrated in a number of ways, including:
 - Use of wording in the requirements to indicate conditionality (e.g., "when applicable," "if any") or proportionality (e.g., "the degree to which");

² ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

³ ISA 330, *The Auditor's Responses to Assessed Risks*

- Recognizing the spectrum of risk concept, building on existing concepts in ISA 200,⁴ ISA 315 (Revised), and ISA 330, and aligning with the direction of the ISA 315 Task Force (see further discussion below);
- Providing application material, along with examples where appropriate, to explain how certain requirements can be applied in a scalable manner.
- Retaining the requirement in ED-540 that the auditor’s further audit procedures shall be responsive to the reasons for the assessment of the risks of material misstatement at the assertion level;
- Retaining the wording from paragraph 7(b) of ISA 330 that 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, and adding a similar reference to paragraph 9 of ISA 330 to paragraph 16.
- Providing a more comprehensive example of scalability in an appendix to the standard (e.g., a side-by-side comparison of how the requirements could be applied for a simple and a more complex accounting estimate).

Spectrum of Risk Concept

10. The Task Force has been coordinating with the ISA 315 Task Force on the changes being proposed to ISA 315 (Revised) to make sure there is appropriate alignment between the two projects with respect to the qualitative inherent risk factors and the spectrum of risk concept.
11. In view of the proposal to remove the low/not low inherent risk threshold, the Task Force believes that the spectrum of risk concept can be an effective way to demonstrate scalability for accounting estimates. This would start with the auditor’s understanding of the nature of the entity and its accounting estimates, including how management makes them. For example, a “simple” estimate often will have a much lower degree of estimation uncertainty, and management’s process for making the accounting estimate (i.e., the use of the method, assumptions, and data, and the selection of the amount and related disclosures in the financial statements) may not be affected to a significant degree by complexity, subjectivity or other inherent risk factors. This would influence the auditor’s consideration of inherent risk for the accounting estimate (e.g., at the lower end of the risk spectrum) and would, in turn, affect the auditor’s assessment of the risks of material misstatement at the assertion level.
12. The auditor’s further audit procedures would be responsive to the reasons for the assessment given to the risks of material misstatement at the assertion level, and would include one or more of the “strategies” (see paragraph 15 of **Agenda Item 2-B**). If, for example, the auditor’s approach for a “simple” estimate included testing management’s process for making the estimate, the auditor would be required to obtain sufficient appropriate audit evidence in accordance with paragraphs 17B to 17H of **Agenda Item 2-B**. However, the nature, timing and extent of those procedures would be commensurate with the assessed risks of material misstatement, taking into account the reasons for the assessment (e.g., the auditor’s work effort would be less extensive if there is little or no complexity or subjectivity in the selection of the method, assumptions or data).

⁴ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

13. The Task Force recognizes that this concept will need to be clearly explained and supported by examples. Accordingly, the Task Force will further develop the application material and will continue to liaise with the ISA 315 Task Force to understand the changes being proposed to ISA 315 (Revised) in this regard, and how the concept can be best included and described in ISA 540 (Revised).

Scalability of the Requirements

14. The Task Force discussed that scalability would be different for certain requirements than for others. For example, the extent of the auditor's understanding of the entity and its environment, and the system of internal control, in relation to accounting estimates required by paragraph 10 of **Agenda Item 2-B** would be based principally on the nature of the entity and its accounting estimates. For example, for a smaller entity that has only simple estimates, the extent of effort in obtaining and documenting the understanding may be influenced by the fact that a single individual may be responsible for making the accounting estimates, there may be no regulatory factors that are relevant, no need for specialized skills or knowledge, and little or no subjectivity in the selection of the method, assumptions and data. Conversely, a large financial institution may have many different types of accounting estimates that are subject to a high degree of estimation uncertainty, involve the use of complex models and subjectivity in the development of assumptions and selection of data, and also may be subject to regulatory factors.
15. While the auditor's understanding is based principally on the nature of the entity and its accounting estimates, the auditor's identification and assessment of the risks of material misstatement, and the response to those assessed risks (paragraphs 13-18C of **Agenda Item 2-B**), are based on the reasons given to the assessment of the risks of material misstatement at the assertion level, and where those risks are assessed along the spectrum of risk. This would involve a more granular consideration of the risk factors (i.e., the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the components of the accounting estimate, and management's point estimate and related disclosures, are affected by complexity, subjectivity and other relevant risk factors).

Matters for IAASB Consideration

The IAASB is asked for its views on:

1. The use of the spectrum of risk to demonstrate scalability, and in particular the wording in paragraphs 3A and A71–A71B in **Agenda Item 2-B**.
2. The approaches to demonstrating scalability described in paragraph 7 above, and whether any other approaches should be considered by the Task Force.
3. Whether the IAASB continues to support the current direction of the Task Force to eliminate the low/not low inherent risk threshold and address scalability in the standard through the spectrum of risk concept and other ways as described above.

3. Use of the Term “Reasonable”

3.1 Background

16. The Explanatory Memorandum to ED-540 noted that the word “reasonable” is used in both extant ISA 540⁵ and ED-540 in the objective and many key requirements. In extant ISA 540, the objective of the standard uses the term “reasonable” for accounting estimates but “adequate” for disclosures, although neither term is defined or explained further. The IAASB concluded that both the accounting estimate and the related disclosures should be “reasonable” in the context of the applicable financial reporting framework, as continuing to use “adequate” may inappropriately suggest that disclosures are less important than the accounting estimate itself.
17. The IAASB considered alternative approaches before concluding that “reasonable” would be the most appropriate terminology, provided that guidance was included as to its meaning. Guidance was provided in ED-540 (paragraph A2) regarding factors that may be relevant to the auditor’s evaluation of whether the accounting estimates and related disclosures are reasonable. Guidance also was provided in paragraph A3 regarding the term “appropriate,” which is used in a number of paragraphs throughout ED-540, including, most importantly, in describing what “reasonable” means.
18. In aligning the objective of ED-540 to refer to “reasonable in the context of the applicable financial reporting framework” for the accounting estimate and related disclosures, the IAASB recognized that ISA 700 (Revised)⁶ uses the terms “reasonable,” “appropriate” and “adequate” in relation to disclosures.⁷ Noting a degree of inconsistency, the IAASB decided not to make conforming amendments to ISA 700 (Revised) in connection with ED-540, but rather to consider the need to do so as part of the planned post-implementation review of the auditor reporting standards.
19. Respondents to ED-540 commented in various ways about the use of the term “reasonable,” including:
 - The inconsistencies with some of the terms in ISA 700 (Revised), including suggestions for conforming amendments to ISA 700 (Revised);
 - Whether “reasonable” should be included in the definitions;
 - Whether using “reasonable” as the evaluation criterion for disclosures related to accounting estimates creates a stronger criterion for these disclosures compared with other disclosures (including qualitative disclosures) in the financial statements; and
 - Consistency of the use of the terms “reasonable,” “appropriate,” and “adequate” throughout the standard.

3.2 Task Force Discussion and Response

20. The Task Force discussed the use of “reasonable” in the objective of the standard, and continues to believe that this is the appropriate criterion for both the accounting estimate and related disclosures. However, in view of the comments received on the inconsistencies with the terminology in ISA 700 (Revised), the Task Force is recommending a conforming amendment to paragraph 13(c) of ISA 700

⁵ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

⁶ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

⁷ ISA 700, paragraphs 13(b), 13(e), and 39(b)(iii)

(Revised), which requires the auditor to “... evaluate whether, in view of the requirements of the applicable financial reporting framework, the accounting estimates made by management are reasonable.” The conforming amendment would add the words *and related disclosures* following “accounting estimates.” See **Agenda Item 2-D** for further details.

21. The Task Force also discussed whether a conforming amendment should be made to paragraph 13(e) of ISA 700 (Revised), which requires the auditor to “... evaluate whether, in view of the requirements of the applicable financial reporting framework, the financial statements provide *adequate* disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.” The Task Force believes that the use of “adequate” in this context is related to the sufficiency and completeness of the disclosures needed to enable the intended users to understand the effect of material transactions and events on the entity’s financial position, financial performance and cash flows. Accordingly, the Task Force is not recommending a conforming amendment to paragraph 13(e).
22. The Task Force also discussed whether conforming amendments may be needed to other ISAs, such as ISA 450⁸ and ISA 705 (Revised),⁹ so that misstatements are consistently determined and that it is clear as to what constitutes a material misstatement related to disclosures, and when a modification to the auditor’s opinion may be required. Although the Task Force is not recommending any conforming amendments to these or other ISAs at this time, it will continue to give thought to this point. In addition, the Task Force will do a comprehensive review of the ISAs to identify whether other inconsistencies in terminology exist in relation to these matters that may need further discussion.
23. The Task Force considered whether the term “reasonable” should be included in the definitions in ISA 540 (Revised) and continues to believe, consistent with ED-540, that doing so could lead to questions or confusion with the many uses of the term in different contexts throughout the ISAs. However, the Task Force concluded that it would be responsive to comments received to clarify the intent of paragraph 6 of the introductory section of the ISA by including words from the application material in paragraph A2 of ED-540 as follows:

“For purposes of this ISA, accounting estimates and related disclosures are considered to be reasonable when all the relevant requirements of the applicable financial reporting framework have been applied appropriately.”

In addition, paragraph A3 has been modified to focus on the term “applied appropriately” rather than “appropriate.”

24. Based on comments received, the Task Force also will undertake a thorough review of the use of the terms “reasonable,” “appropriate,” and “adequate” throughout the standard at a later stage in the process and challenge whether the use of a particular term is what was intended in that context.

Matters for IAASB Consideration

The IAASB is asked for its views on:

4. Whether it supports the proposed conforming amendment to paragraph 13(c) of ISA 700 (Revised) as presented in **Agenda Item 2-D**.

⁸ ISA 450, *Evaluation of Misstatements Identified during the Audit*

⁹ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor’s Report*

5. Whether any additional conforming amendments may be needed to address the comments received with respect to the term “reasonable.”
6. The changes to paragraphs 6 and A3 of **Agenda Item 2-B**.

4. Professional Skepticism

4.1 Background

25. Question 2 in the Explanatory Memorandum of ED-540 asked respondents whether the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates. The Task Force’s preliminary analysis of the comments received on this question was discussed with the IAASB at the October 2017 meeting. See **Supplement B to Agenda Item 2** for the October meeting.
26. Based on the preliminary analysis of comments, the Task Force noted that respondents generally believed that the approach taken in ED-540 appropriately reinforces the application of professional skepticism when auditing accounting estimates. Several aspects of ED-540 were mentioned as key improvements in this regard, including the stand-back provision in paragraph 23, which requires the auditor to consider all audit evidence obtained, whether corroborative or contradictory, when evaluating whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.
27. Specific comments were received noting that the effective exercise of professional skepticism is important with respect to the auditor’s evaluation of management’s judgments relating to accounting estimates, particularly when those judgments are subjective and there is greater opportunity for management bias. This involves evaluating whether management’s judgments are appropriate, including whether there is evidence to suggest that other alternatives (e.g., methods, assumptions or data) may be more appropriate in the circumstances, and questioning or challenging management when it is appropriate to do so. Accordingly, suggestions were received for the IAASB to consider the use of words such as “question” or “challenge” in the requirements to drive appropriate auditor behavior in the audit of accounting estimates, including the exercise of professional skepticism.
28. Respondents also commented in various ways about the link between the application of professional skepticism and the consideration of possible management bias and the need for management judgment in making accounting estimates. This included a recommendation that the IAASB include examples of how auditors can demonstrate the application of professional skepticism for accounting estimates that are subject to a high degree of management judgment, and therefore may be more susceptible to the potential for management bias (see paragraph A85 of ED-540).

4.2 Task Force Discussion and Response

29. The Task Force discussed the comments received and acknowledges that using terms such as “challenge” or “question” would be responsive to the calls, particularly from regulators and investors, for stronger language to reinforce the importance of applying professional skepticism in auditing accounting estimates. The Task Force also notes that the IAASB’s Professional Skepticism Working Group is exploring the use of such terminology in the ISAs, including implications for auditor behavior as well as considering any unintended consequences. The Task Force will seek input from the Working Group as the Task Force continues to discuss additional ways to reinforce professional skepticism in the requirements and application material in ISA 540 (Revised).

30. Based on the support from respondents for the wording of the stand-back requirement with respect to audit evidence (“consider all evidence obtained, whether corroborative or contradictory”), the Task Force discussed whether wording could be added to the stand back to enhance the application of professional skepticism. In this regard, the Task Force also considered whether including similar wording earlier in the requirements section may be more effective in driving actions that are more likely to ensure that the auditor identifies potential alternative sources of evidence that may be contradictory. Accordingly, the Task Force proposes to add the following wording to paragraph 15 of **Agenda Item 2-B**:

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 designing and performing the further audit procedures, the auditor shall seek to obtain relevant audit evidence from available sources, whether it corroborates or contradicts management’s assertions.

31. The Task Force believes that this addition to the requirement in paragraph 15 will complement the auditor’s overall evaluation of accounting estimates in paragraphs 22 to 23A of **Agenda Item 2-B**. This includes evaluating whether sufficient appropriate audit evidence has obtained for each accounting estimate and, when evaluating whether each accounting estimate is reasonable or misstated, considering all relevant audit evidence obtained, whether corroborative or contradictory.
32. Based on comments received as discussed in paragraph 28, the Task Force will continue to discuss ways to reinforce the link between the application of professional skepticism and the consideration of possible management bias and the need for management judgment in making accounting estimates.

Matters for IAASB Consideration

7. The IAASB is asked for its views on the proposed additional wording to paragraph 15 of **Agenda Item 2-B** as described in paragraph 30.

5. Respondents’ Comments on the Application Material or Calling for Additional Guidance

5.1 Background

33. One key theme of the responses to ED-540 was that the application material was complex and needed restructuring to better support a proper understanding of the concepts and application of the requirements in the ISA. ED-540 includes 159 paragraphs of application material, 151 of which are specific to the 18 requirements. One requirement (paragraph 10) is linked to approximately one third of the application material. Another two requirements (paragraphs 13 and 19) are linked to approximately another one third of the application material. Many comments were raised on the application material, in the responses to the ED, both positive and negative. The Task Force has identified 741 separate such comments through a detailed analysis of the responses. The Task Force also identified possible ways to address the application material in ED-540 through a separate review being conducted with input from a national standard-setter.¹⁰

¹⁰ This work has been done with the assistance of Jan Thijs Drupsteen (NBA). The NBA response to the ED made a particular point that there appeared to be much educational guidance in the AM that might not need to be included there.

5.2 Purpose of the Analysis and Review

34. The primary purpose of the analysis and review, beyond understanding the extent and nature of respondents' comments, was to consider how to modify and restructure the application material in ED-540 to make it more effective in the final revised standard, taking into account both the comments received and the proposed modification and restructuring of the requirements.
35. The Task Force recognized that the restructuring of the requirements and any other changes to the application material could be complex, with potentially several reasons for considering changes to particular paragraphs. As a result, the approach taken to the analysis and review would need to support a carefully coordinated and controlled approach to making the resulting changes to the application material. The approach would also need to provide a holistic overview of the scope and nature of possible changes to the application material, to support effective Task Force and Board input and drafting implementation.

5.3 Approach Taken to the Analysis and Review

36. Since the October Board meeting, the Task Force has been analyzing and reviewing the application material in ED-540, with a view to restructuring it under four "pillars" as follows (status and remaining steps indicated).

Pillar 1 - Analyze and Categorize Extracts from All Responses that Include Comments on Application Material or Calls for More Guidance, and Develop Strategies for Responding

37. Detailed tables of comments have been prepared, with a separate table for extracts from responses to questions 1–6 and question 8 and general comments.¹¹ These tables, and some further explanatory material about how they have been developed, are included in **Supplement B to Agenda Item 2**. This information is made available to the Board for reference purposes and is not intended for discussion.
38. The tables show, for each comment:
 - An identifying number and the respondent's abbreviated name;
 - A brief summary of the essence of the comments made, set out in different columns for those comments that were supportive or asking for more guidance and for those that were negative or wanted less application material;
 - Highlighting of those extracts that refer to specific application material paragraphs in ED-540; and
 - Categories (reflecting themes in comments) that have been applied to each comment, for purposes of analysis and development of a strategy to respond to the comments.
39. Categories of general themes identified in comments include, for example:
 - Comment provides explicit support for particular guidance;
 - Comment disagrees with or questions particular guidance;
 - Comment identifies specific matters on which more guidance is requested; and

¹¹ Question 7 relates to the consequential and conforming changes to other ISAs and is being covered separately.

- Comment identifies application material that should be elevated to a requirement.
40. Summaries have been prepared, for each table, showing, for each category of general theme identified in the comments:
- The identifying numbers and abbreviated name of respondents for comments in that category (highlighting those that refer to specific paragraphs of ED-540 application material); and
 - A preliminary strategy that the Task Force is following in considering in addressing the comments in that category. These summaries are provided in **Agenda Item 2-E.1**.
41. The themes in the comments have also been considered holistically across all of the tables. As a result, they have also been classified, at a high level, under one of the following six headings, in relation to certain guidance:
- Delete it (in view of challenges to the validity, duplication or otherwise);
 - Dilute it (diminish the extent or standing of the guidance);
 - Reorganize it (relocate it within ISA 540 or move it to non-authoritative guidance);
 - Support its retention (support for particular guidance in ED-540);
 - Increase it (areas where more guidance is requested); and
 - Strengthen it (elevate application material guidance to a requirement, or emphasize the expectation of the auditor by using stronger language).
42. Within each of these classifications, a number of sub-classifications have been identified. These classifications and sub-classifications have also been mapped to each applicable category of themes in comments identified in responses (in the tables referred to in paragraph 37) and to the corresponding individual comments. This mapping is shown in the summaries provided in **Agenda Item 2-E.1**. The detailed mapping and analysis is provided for reference as **Supplement A to Agenda Item 2**.

Pillar 2 – Conducting a Separate Review, with External Input, to Identify Indicators of Possible Ways the Application Material in ED-540 Could be Further Clarified and Restructured

43. A critical review of the application material in ED-540 is being conducted, with input from a national standard-setter, with a particular focus on clarification. The objective of this review is to identify application material paragraphs that could potentially be restructured, redrafted, relocated or deleted for different reasons. The review has been performed so far for the application material to paragraphs 10, 13, 19 and 20 of ED-540.
44. Examples of categories identified, include, for example, application material that:
- Is “educational in style”;
 - Duplicates material in another ISA;
 - Duplicates material elsewhere in ED-540; or
 - Could be further rationalized.
45. An “inventory” of all the application material in ED-540 has been prepared showing, for each paragraph, a brief summary of what the paragraph covers, the categories of comments in responses

(as referred to in paragraphs 43–44), and a preliminary working strategy to address the applicable identified categories. Such strategies include, for example:

- Restructuring application material that is “educational in style”, to be clearer in what is expected of the auditor, relocate it outside the application material or delete it;
- Rewording guidance to improve clarity;
- Eliminating duplications, e.g. by replacing with cross-references in footnotes, or deleting;
- Considering the merits of specific requests to add further guidance and, if agreed, add such guidance; or
- Considering the merits of specific requests to elevate application material to requirements or definitions and, if agreed, elevate it (See Pillar 3 below).

46. The inventory of application material in ED-540, which is included at **Agenda Item 2-E.2**, shows the analysis of the application material performed to date and the working strategies developed for that application material. This also includes details of each of the categories identified in the review. Further approaches identified under Pillar 1 relevant to specific application material paragraphs will be included in the inventory if not already covered (see section 5.4).

Pillar 3 – Addressing Requests to Elevate Application Material

47. As part of the analysis described under Pillar 1, a significant number of comments (41, mainly from regulators and oversight bodies) were identified, which suggested that certain parts of the application material should be elevated, either to requirements or to other paragraphs within the body of the ISA (for example, the definitions). Such elevation requests are being addressed separately, given their potential impact on the requirements (see Appendix D below).

Pillar 4 – Responding to Restructuring and Amendment of the Requirements

48. Addressing comments on the introductory paragraphs and requirements in ED-540 has resulted in them being significantly restructured. The Task Force will in due course remap the ED-540 application material to the revised requirements, as necessary, and add to the inventory any need for consequential redrafting or restructuring of the ED-540 application material or for new application material.

5.4 Status of Strategies for Responding to Comments in the Responses to ED-540

49. It is important to understand that the presentation of items in the tables in **Supplement A to Agenda Item 2** reflects the views of the respondents. The Task Force has not yet addressed all of them individually, to determine what specific action, if any, to propose to address them. The Task Force therefore does not necessarily agree with all of the individual comments raised.
50. The Task Force will develop a response, or determine that no action is necessary, to address each of the comments. These will be developed holistically, taking into account the input available to the Task Force under each of the four pillars. As approaches to responding to particular requests are agreed in principle, they will be added to the application material inventory (see **Agenda Item 2-E.2**).
51. The Task Force is in the process of reviewing the comments, considering their merits and forming views as to what action, if any, should be taken. In doing so, the Task Force is following the broad strategies that are set out in the summaries of themes referred to above.

52. The tables and the strategies reflected in them are working documents for the Task Force and will be updated as the Task Force’s work to restructure the application material continues.

5.5 Key Findings in the Analysis of Responses

53. The summaries in Appendix C show that there were a very wide range of comments across all categories of respondents.
54. Of the 741 comments analyzed, over 600 either support the application material (131), in principle, or want it to be enhanced or supplemented (423), or strengthened further (51). The comments calling for enhancement or more guidance came from a broad range of respondents, most significantly from regulators and oversight bodies (103), professional bodies (145), national standard setters (60) and audit firms (88). Calls for the standards to be strengthened (primarily through elevation of application material and by strengthening language to support professional skepticism) came mostly from the regulators and oversight bodies (43 out of 51 in total).
55. There is a good degree of overlap between the comments identified in responses that fall within the major classifications “delete”, “dilute” and “reorganize” and the findings from the separate review of the application material (see Pillar 2). These will be carefully coordinated in developing responses.
56. The most significant number of comments in the analysis are within the major classification “increase”. Appendix C shows that there are some areas that attracted a particularly high number of responses, including SME audits (16), professional skepticism (22), controls (19), inherent risk assessment (20), the auditor’s development of a point estimate or range (42 comments on this alone) and calls to clarify the meanings of certain terms and the application of certain requirements (33).
57. The Task Force recognizes that the requests for increasing or strengthening the application material will need to be considered along with comments received regarding the overall length, complexity and readability of the standard. In its further discussions on the application material, the Task Force will seek an appropriate balance, with the objective of ensuring that the application material is clear and understandable, and appropriately supports the application of the related requirements.

Matters for IAASB Consideration

8. The Board is asked for its views on:
- (a) The approach being adopted to address the restructuring and enhancement of the application material.
 - (b) The findings of the analysis of comments in responses to ED-540 that refer to guidance or the application material (Pillar 1), and the broad preliminary strategies that are being developed to address them, as set out in the summary of categories of themes in the comments (**Agenda Item 2-E.1**) and in the summary of major classifications of those themes (**Appendix C**).
 - (c) The findings of the separate critical review of the application material (Pillar 2) completed to date, or on the working strategies developed to address them, as set out in the application material inventory (**Agenda Item 2-E.2**).

- (d) The approaches being taken to the requests for elevation (Pillar 3, see Appendix D) and the implications for the application material of the proposed restructuring and enhancement of the requirements (Pillar 4).

6. Conforming and Consequential Amendments

58. The Task Force discussed the comments received on the conforming and consequential amendments included in ED-540. In addition to proposed changes to ISA 500 to address the use of external information sources, these amendments also covered ISA 260 (Revised) and ISA 580.
59. Significant matters noted from the comment letters relating to the proposed amendments to ISA 500, and the relationship to the requirements and guidance in ISA 540, are included in **Agenda Item 2-A**, along with how the Task Force has responded.
60. In discussing the comments received and proposed revisions to ED-540, the Task Force identified other matters for which it is proposing conforming or consequential amendments. These amendments relate to ISA 200, ISA 230, and ISA 700 (Revised), and are included in **Agenda Item 2-D**.
61. In response to the discussions at the October 2017 IAASB meeting about the separate and/or combined assessment of inherent and control risk, the Task Force is proposing to remove references to a combined assessment of inherent risk in ISA 200 (see **Agenda Item 2-A**).
62. In discussing the proposed amendments to ISA 260 (Revised) and revisions to paragraphs 26 and A155 of ED-540, the Task Force noted a certain amount of duplication between the matters in paragraph A155 and those in Appendix 2 of ISA 260 (Revised) (titled “Qualitative Aspects of Accounting Practices”).
63. The Task Force noted that some of the material in paragraph A155 is intended to support paragraph 16(a) in ISA 260 (Revised), though some amendments are already proposed for Appendix 2 so that the material in ISA 260 is complete. The Task Force is considering whether such material should be moved exclusively to Appendix 2 in ISA 260 (Revised) (with an appropriate cross-reference in ISA 540 (Revised)), or whether paragraph A155 should remain largely as is (subject to refinements), but be reorganized so that the material related to Appendix 2 of ISA 260 (Revised) comes first, followed by other matters.

Matters for IAASB Consideration

9. The Board is asked to provide its views on **Agenda Item 2-D**. The Board is also asked to decide on the balance between ISA 540 and ISA 260 regarding matters that may be communicated to those charged with governance (see paragraphs 62–63 above).

Appendix A

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 and coordination with other IAASB Task Forces and Working Groups relating to the ISA 540 project.

Task Force Activities since the last IAASB Discussion

2. The ISA 540 Task Force has held one physical meeting and one teleconference since the last IAASB discussion in October 2017.
3. The ISA 540 Task Force met once with the ISA 315 (Revised) Task Force at the September 2017 IAASB meeting.

Outreach

4. The leadership of the ISA 540 Task Force has had teleconferences with representatives of the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the Global Public Policy Committee, the Committee of European Auditing Oversight Bodies, the International Valuation Standards Council, and staff of the US Public Company Accounting Oversight Board.
5. On December 6, the Task Force will also have an informal call with the IAASB's Consultative Advisory Group.

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ISA 540 (Revised)

The Board discussed the ISA 540 Task Force's (the Task Force) analysis of responses to the Exposure Draft (ED) of Proposed ISA 540 (Revised)¹² with respect to the scalability of the ISA and the risk assessment and work effort requirements, as well as the conforming and consequential amendments to ISA 500. The Board also discussed initial revisions to key paragraphs in the risk assessment and work effort requirements and selected application material.

SCALABILITY

With respect to scalability the Board:

- Generally supported the Task Force's views to consider removing the threshold and to reinforce scalability by reinforcing the existing concept of the spectrum of risk and drawing upon the existing material in ISA 315 (Revised)¹³ and ISA 330.¹⁴ The Board noted the importance of drafting appropriate application material and examples to support this approach;
- Highlighted that the persuasiveness of the audit evidence needed depends on the risk of material misstatement; and
- Suggested that a flow chart and examples be included with the final ISA 540 (Revised) to explain how proposed ISA 540 (Revised) can be applied to simpler estimates.

RISK ASSESSMENT AND WORK EFFORT

With respect to the identification and assessment of the risks of material misstatement and the response thereon the Board:

- Supported for the Task Force's proposed way forward with respect to the risk factors;
- Supported aligning the terms used for the risk factors with those being considered for similar factors in the revision of ISA 315 (Revised) and in the U.S. Public Company Accounting Oversight Board's proposals on auditing accounting estimates;
- Supported the proposed structure of the standard, including basing the work effort requirements around the testing strategies and methods, data, and assumptions;
- Noted the importance of emphasizing professional skepticism;
- Noted that the procedures that the auditor will need to perform will differ for each of the testing strategies in terms of the degree of reference to methods, data, and assumptions; and
- Noted the importance of coordination between the ISA 540 Task Force and the ISA 315 (Revised) Task Force on the risk factors and other matters.

¹² Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

¹³ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

¹⁴ ISA 330, *The Auditor's Responses to Assessed Risks*

REVISIONS TO KEY PARAGRAPHS IN THE RISK ASSESSMENT AND WORK EFFORT

The Board generally supported the Task Force's revisions to the risk assessment and work effort and asked the Task Force to consider:

- Whether the repetition of requirements that exists in other ISAs is necessary;
- To give more prominence to estimation uncertainty in identifying and assessing the risks of material misstatement; and
- To include the risk factors more prominently in the risk assessment and to reduce the duplication in the work effort requirements.

OTHER MATTERS

The Board also:

- Supported the Task Force's proposed way forward with respect to the conforming and consequential amendments to ISA 500;¹⁵
- Supported the analysis of the responses received to the ED, except for clarifying some matters on the responses related to scalability; and
- Expressed interest in how the Task Force took into account the results of field testing.

The IAASB also discussed the progress of the finalization of the ISA in response to the comments received. It was noted that there were a relatively large number of respondents and some letters were particularly detailed. In light of this, the Board agreed to reflect further as the finalization of the ISA progresses.

IAASB CAG CHAIR'S REMARKS

Mr. Dalkin supported the revised structure of the standard and expressed the view that a flow chart would help explain the revised structure of proposed ISA 540 (Revised). He also noted that scalability and complexity are related and that removing the threshold reduces the complexity and can therefore help make the standard more scalable.

PIOB REMARKS

Mr. van Hulle noted that financial institutions are subject to many prudential requirements and that including a linkage to those requirements would assist auditors of those entities.

WAY FORWARD

For the December 2017 Board meeting, the Task Force will redraft the requirements of proposed ISA 540 (Revised) and will prepare and an overview of proposed changes to the application material.

¹⁵ ISA 500, *Audit Evidence*

Appendix C

Analysis of Comments that Mention Guidance or Application Material by Major Classifications and Sub-Classifications

Count of Comment identifier and respondent Row Labels	Column Labels									
	Body	Invest	Reg	TCWG	NASS	Firm	PS	Acad	Ind	Grand
1-DELETE	19	1	6		15	17	7		3	68
2-DILUTE	11			1	17	4	7			40
3-REORG	7		9		5	6			1	28
4-SUPPORT	41	4	26		10	23	21	1	5	131
5-INCREASE	145	4	103		60	88	18	1	4	423
6-STRENGTHEN	2		43		5		1			51
Grand Total	225	9	187	1	112	138	54	2	13	741

ISA 540 — Issues and Task Force Recommendations
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Count of Comment identifier and respondent	Column Labels									
	Body	Invest	Reg	TCWG	NASS	Firm	PS	Acad	Ind	Grand Total
1-DELETE	19	1	6		15	17	7		3	68
1.A: Concerns / disagree	19	1	4		12	17	7		3	63
1.B: Delete					3					3
1.C: Duplication			2							2
2-DILUTE	11			1	17	4	7			40
2.A: Demote R to AM	6				2	2				10
2.B: Rationalise and/or reduce guidance	4			1	13	1	6			25
2.C: Educational					1					1
2.D: Imbalance	1				1	1	1			4
3-REORG	7		9		5	6			1	28
3.A: Relocate / add links - within AM to ISA 540	7		9		3	3				22
3.B: Relocate - to other ISA					1					1
3.C: Relocate - to non authoritative guidance					1					1
3.D: Consider impact on other ISAs						3			1	4
4-SUPPORT	41	4	26		10	23	21	1	5	131
4.A: Supportive	41	4	26		10	23	21	1	5	131
5-INCREASE	145	4	103		60	88	18	1	4	423
6-STRENGTHEN	2		43		5		1			51
6.A: Elevate AM to requirement	2		31		3		1			37
6.B: Elevate AM to main body of ISA 540			3		1					4
6.C: Language of challenge/question			8		1					9
6.C: Review and reduce use of "may" in AM paragraphs			1							1
Grand Total	225	9	187	1	112	138	54	2	13	741

ISA 540 — Issues and Task Force Recommendations
IAASB Main Agenda (December 2017)

Count of Comment identifier and respondent Row Labels	Column Labels									
	Body	Invest	Reg	TCWG	NASS	Firm	PS	Acad	Ind	Grand
1-DELETE	19	1	6		15	17	7		3	68
2-DILUTE	11			1	17	4	7			40
3-REORG	7		9		5	6			1	28
4-SUPPORT	41	4	26		10	23	21	1	5	131
5-INCREASE	145	4	103		60	88	18	1	4	423
5.AA: More or enhanced guidance - generally	4					1				5
5.AB: More or enhanced guidance - complex / new types of AE	2		6		2	1				11
5.AC: More or enhanced guidance - SME audits	6		2		4	3	1			16
5.AD: More or enhanced guidance - scalability	8					3			1	12
5.AE: More or enhanced guidance - term "reasonable"			1		2					3
5.AF: More or enhanced guidance - professional skepticism	11	1	4		3	2	1			22
5.AG: More or enhanced guidance - materiality	3		2		3	1	1			10
5.AH: More or enhanced guidance - management bias		1	2							3
5.AI: More or enhanced guidance - models			6		1					7
5.AJ: More or enhanced guidance - controls	6		10		1	2				19
5.AK: More or enhanced guidance - disclosures	2		2		1		1			6
5.AL: More or enhanced guidance - interaction with other ISAs			2							2
5.AM: More or enhanced guidance - risk factors						1				1
5.AN: More or enhanced guidance - IR assessment	12		1		5	2				20
5.AO: More or enhanced guidance - three audit approaches for AEs	3					8				11
5.AP: More or enhanced guidance - proposed alternative approach to work effort	3				2	5	2			12
5.AQ: More or enhanced guidance - auditor's PE or R	12		14		9	7				42
5.AR: More or enhanced guidance - evaluating misstatements	4		3			1				8
5.AS: More or enhanced guidance - SAAE (paras. 17-19)					1	1			1	3
5.AT: More or enhanced guidance - not appropriately understood or addressed EU	3		1			4				8
5.AU: More or enhanced guidance - significant risks	3		1			2	3			9
5.AV: More or enhanced guidance - documentation	3		1							4
5.AW: More or enhanced guidance - specific topics or AM paragraphs	41	2	36		20	33	7	1	2	142
5.BA: Clarify	13		3		6	10	1			33
5.CA: More guidance (non-authoritative) - complex / new types of AEs	1		1							2
5.CB: More guidance (non-authoritative) - specific topics	2									2
5.CB: More guidance (non-authoritative) - specific topics	3		3			1	1			8
5.DA: Post Implementation monitor and address urgent issues			2							2
6-STRENGTHEN	2		43		5		1			51
Grand Total	225	9	187	1	112	138	54	2	13	741

Appendix D

Elevations of Application Material

1. This Appendix lists the paragraphs, or parts thereof, in the application material that were requested to be elevated to the requirements by respondents, and the Task Force's proposed response.

Paragraph Number in ED-540	Task Force Response
(a) A2, the description of “reasonable” (<i>covered in Section 9, Issue 9 of Agenda Item 1 from the meeting in Brussels</i>);	The Task Force has responded by including a description of “reasonable” in the Key Concepts section of the draft ISA (see paragraph 6) ¹⁶
(b) A9, auditor’s primary considerations in performing the risk assessment procedures and related activities required by paragraph 10	The Task Force has decided not to propose elevating this paragraph, but will consider further refinement of paragraph 10 to align with the use of “understanding that is sufficient and appropriate” to align with revisions to proposed ISA 315 (Revised).
(c) A73, examples of accounting estimates for which the inherent risk may not be low	The Task Force has decided not to propose elevating this paragraph as the threshold of low/not low inherent risk has been removed.
(d) A78, other relevant factors that the auditor may consider in identifying and assessing the risks of material misstatement	The Task Force has decided not to propose elevating this paragraph, but has included a specific reference to other relevant risk factors in paragraph 13, and has added those words to paragraph 26 to direct the auditor to take these factors into account in considering which matters to communicate to those charged with governance.
(e) A96, when the further audit procedures in paragraph 15(a) do not provide sufficient appropriate audit evidence	The Task Force has decided not to propose elevating this paragraph as it would be repetitive of ISA 330. Instead, the Task Force has enhanced the cross references to ISA 330 in the requirement.
(f) A98, when the auditor intends to rely on relevant controls or substantive procedures alone cannot provide sufficient and appropriate audit evidence	The Task Force has reinforced paragraph 16 to take into account how the extent of testing of relevant controls may vary. The Task Force did not see merit in otherwise elevating some or all of paragraph A98 to the requirements.
(g) A101, consideration of other available valuation concepts, techniques or factors,	The Task Force has decided not to propose elevating this paragraph as paragraphs 17B(a)/

¹⁶ References to paragraph numbers in this column are to Agenda Item 2-B.

<p>types of assumptions or sources of data that, in the circumstances, might have been more appropriate or more generally accepted</p>	<p>17C(a)(i) and 17 D(a)(i) require the auditor to select, respectively, methods, assumptions and data that are appropriate in the context of the requirements of the applicable financial reporting framework. The Task Force was of the view that requiring the auditor to consider whether, for example, “there are other more appropriate methods, assumptions and data” is too subjective in certain cases and is therefore better placed in the application material.</p>
<p>(h) A105, understanding or interpreting data</p>	<p>The Task Force has decided not to propose elevating this paragraph, but will consider amending this paragraph to help provide more guidance to the auditor on the matters to consider.</p>
<p>(i) A114, relating to management’s consideration of alternative assumptions or outcomes when understanding and addressing estimation uncertainty</p>	<p>The Task Force will give further consideration to this point.</p>
<p>(j) A120-A123, disclosures that may be required by the applicable financial reporting framework and matters that may be relevant in obtaining sufficient appropriate audit evidence about the reasonableness of management’s point estimate and related disclosures</p>	<p>The Task Force has decided not to propose elevating these paragraphs but will consider including an appropriate “hook” in the requirement.</p>
<p>(k) A126, requesting management to consider alternative assumptions or to provide additional disclosure relating to estimation uncertainty when, in the auditor’s judgment, management has not appropriately understood or addressed estimation uncertainty</p>	<p>The Task Force will give further consideration to this point.</p>
<p>(l) A134, first sentence, stating that the auditor’s range may be multiples of materiality</p>	<p>The Task Force has decided not to propose elevation as the first sentence is a statement of fact, rather than an obligation on the auditor.</p>
<p>(m) A135, stating that paragraph 21 applies regardless of whether the auditor is required to perform procedures under paragraph 19</p>	<p>The Task Force has decided not to propose elevating this paragraph as the restructuring of the requirements may have made this concern less critical.</p>
<p>(n) A142-A146, guidance on misstatements</p>	<p>The first sentence of paragraph A142 has been elevated to the requirements, and that paragraph</p>

	(paragraph 23 of Agenda Item 2-B) also makes reference to factual, judgmental, and projected misstatements.
(o) A155, guidance on when a significant accounting practice is acceptable under the applicable accounting framework, but is not the most appropriate to the particular circumstances of the entity	The Task Force will give consideration to proposing a conforming amendment to ISA 260 (Revised) ¹⁷ in this regard to put all the communication guidance in one place.
(p) A158, guidance on documentation	The Task Force has decided not to propose elevating this paragraph at this time, but will give further consideration to the detail in the documentation requirement.

¹⁷ ISA 260 (Revised), *Communication with Those Charged with Governance*