

**Proposed ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures – Issues Paper****Introduction**

1. This paper is organized as follows:
  - Section I: Overarching Issues.
  - Section II: Proposed ISA 540 (Revised).
  - Section III: Conforming and Consequential Amendments.

**Section I – Overarching Issues****Clarity and Understandability**

2. Many respondents to the Exposure Draft (ED) noted concerns about the clarity, understandability, and practicality of implementation of the standard generally, but specifically about:
  - The work effort paragraphs; and
  - The application material.

*Work Effort*

3. The IAASB is of the view that enhancements to the structure of the work effort requirements could alleviate some of the concerns raised.
4. The IAASB therefore changed the structure of the work effort section of the ISA so that it follows an approach to auditing accounting estimates that is more closely aligned with the way management makes accounting estimates and how the auditor audits them. This is similar to the structure in extant ISA 540<sup>1</sup> and the proposed standard of the United States Public Company Accounting Oversight Board (PCAOB). Under the new structure, the response to the assessed risks of material misstatement is driven by the selected testing strategy. For each of the testing strategies, objectives-based requirements are structured around methods, assumptions and data. The application material explains how the inherent risk factors (complexity, subjectivity and estimation uncertainty) affect the auditor's work effort relating to methods, assumptions and data. The objectives-based procedures will vary to some extent depending on the strategy chosen.
5. The flow chart included in Appendix 1 sets out how the IAASB restructured the work effort requirements.

*Application Material*

6. The Task Force has analyzed, reviewed and discussed the application material, with a view to streamlining and restructuring it to:
  - Delete or re-purpose material that was considered to be educational in nature, or repetitive of guidance in other ISAs;

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<sup>1</sup> Extant ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

- Reorganize paragraphs (or specific sentences within paragraphs) to better align with the restructured requirements, including changes to the requirements discussed with the IAASB in December 2017;
  - Change certain parts of the application material that was considered to be educational in style to include relevant considerations for the auditor to support the consistent and effective implementation of the requirements;
  - Make it more concise and understandable; and
  - Add guidance, including examples, where appropriate to address specific comments received on ED-540 (see below).
7. A significant number of respondents asked for additional guidance or examples, particularly with respect to audits of small and medium sized entities, professional skepticism, internal controls, inherent risk assessment, the auditor's development of a point estimate or range, and clarification of the meanings of certain terms and the application of certain requirements.
8. The Task Force carefully considered these comments, recognizing that the requests for increasing or strengthening the application material need to be considered along with comments received regarding the overall length, complexity and readability of the standard. In working through the Task Force's detailed analysis of the comments, and in its further discussions on the application material, the Task Force sought 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.
9. The Task Force noted that very few comments were received on Appendices 1 and 2 of ED-540, but did make some changes as a result of the restructuring of the application material. Several paragraphs of application material from ED-540 were moved to Appendix 1 as the Task Force determined that they were more educational in style but nonetheless helpful material relevant to the subject matter of the Appendix. In addition, Appendix 1 has been updated to provide clarifications and strengthen the integration with Appendix 2. Appendix 2 has been updated to provide clarifications and, in particular, to address comments received on ED-540 asking for more explanation about the interrelationship among the inherent risk factors and how estimation uncertainty relates to subjectivity and complexity.

#### **Matters for IAASB Consultative Advisory Group (CAG) Consideration**

1. The IAASB CAG is asked for its views on whether the current draft (as presented in **Agenda Item B.2**) sufficiently addresses the concerns raised on exposure regarding the readability and understandability of the standard.
2. Do representatives support the revised work effort paragraphs (paragraphs 15–18D of **Agenda Item B.2**), particularly how they have been restructured to better align with how management makes accounting estimates and how they are audited, which is also consistent with extant ISA 540 and the PCAOB proposal?

#### **Scalability**

10. 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 IAASB considered whether the threshold should be clarified, or whether it should be removed and replaced with an alternative approach to support scalability.

11. The IAASB concluded that removing the threshold addresses the concerns of respondents about complexity and the relationship to other ISAs (in particular ISA 315 (Revised))<sup>2</sup>, while also being responsive to other comments requesting further guidance to make the threshold more operable in practice. The IAASB noted that 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.
12. The IAASB recognizes the importance of making sure that ISA 540 (Revised) is 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).
13. Scalability has been introduced and demonstrated in a number of ways, including:
  - Recognizing the spectrum of risk concept, building on existing concepts in ISA 200,<sup>3</sup> ISA 315 (Revised), and ISA 330,<sup>4</sup> and aligning with the direction of the ISA 315 Task Force;
  - Use of wording in the requirements to enhance scalability, including:
    - Indicating conditionality (e.g., "when applicable," "if any") or proportionality (e.g., "the degree to which");
    - 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; and
    - 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 application material, along with examples where appropriate, to explain how certain requirements can be applied in a scalable manner; and
  - Providing a more comprehensive example of scalability in an appendix to the standard.

#### *Spectrum of Risk Concept*

14. 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 inherent risk factors and the spectrum of risk concept.

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

<sup>3</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>4</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

15. In view of the proposal to remove the low/not low inherent risk threshold, the IAASB 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 management's point estimate 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.
16. 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 B.2**). 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 17A to 17F of **Agenda Item B.2**. 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).

#### *Scalability of the Requirements*

17. 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 B.2** 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.
18. While the auditor's understanding is based principally on the nature of the accounting estimate and the facts and circumstances of the entity, 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 B.2**), 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).

#### *Application Material*

19. The Task Force has also sought to provide wording and examples in the restructured and revised application material, taking into account comments from respondents to ED-540 and from the IAASB that scalability relates more to the nature of the estimate than to the size of the entity. In that regard, the Task Force has considered the application material under the sub-heading "Considerations Specific to Smaller Entities" and has included it under a separate "Scalability" sub-heading or merged it with other relevant application material.
20. Specific paragraphs of the application material that address scalability include:
  - A8A, A8B and A10, relating to obtaining an understanding of the entity and its environment;
  - A71-A71B, relating to the concept of the spectrum of inherent risk and spectrum of risk of material misstatement (paragraphs to be updated based on further discussions with the ISA 315 Task Force); and
  - A94, relating to the nature, timing and extent of the auditor's further audit procedures.

#### *Additional Scalability Example(s)*

21. In its December 2017 meeting, the IAASB discussed the option to provide 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). The Task Force continues to believe that this would be helpful, in particular to demonstrate the "up and down" scalability in the standard for both lower and higher risk accounting estimates.
22. The Task Force developed one example which is included in the CAG reference paper.

#### **Matters for IAASB CAG Consideration**

3. The IAASB CAG is asked for its views on whether the current draft sufficiently addresses calls for scalability of the standard, including scalability in the:
  - (a) Risk assessment (paragraph 10 of **Agenda Item B.2**) and
  - (b) Response to the assessed risks of material misstatement (paragraph 17-18D of **Agenda Item B.2**).

#### **Professional Skepticism**

23. 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.
24. Based on the analysis of comments, the IAASB 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, 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.

25. 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.
26. 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.
27. 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 IAASB discussed whether wording could be added to the stand back to enhance the application of professional skepticism. In this regard, the IAASB decided to include similar wording earlier in the requirements section as this may be more effective in driving actions that are more likely to ensure that the auditor seeks audit evidence from relevant sources, even if that evidence may be contradictory. The following wording was added to paragraph 15 of **Agenda Item B.2**:

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.<sup>5</sup> The auditor shall design the further audit procedures to seek audit evidence from relevant sources, regardless of whether such audit evidence is evaluated to be corroborative or contradictory.
28. 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 B.2**. 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.
29. The Task Force has added application material (paragraph A92E) to explain that the auditor is not expected to conduct an exhaustive search for audit evidence from all relevant sources. However, the audit evidence obtained needs to be more persuasive the higher the risk of material misstatement. As inherent risk increases, it is therefore likely to be more important for the auditor to consider whether there may be other relevant sources of audit evidence that may be evaluated to be corroborative or contradictory in nature.
30. The Task Force also discussed other ways to emphasize in ISA 540 the importance of exercising professional skepticism in auditing accounting estimates. In this regard, the Task Force further considered whether to add a specific requirement to document how the auditor exercised

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<sup>5</sup> ISA 330, paragraph 7(b)

professional skepticism with respect to accounting estimates. The Task Force reflected on previous discussions, including discussions with the IAASB, and concluded that adding a specific documentation requirement to paragraph 27 would not be appropriate. Rather, the Task Force explored a possible conforming amendment to paragraph A7 of ISA 230.<sup>6</sup> In addition, to build on and support the proposed amendment to paragraph A7 of ISA 230, the Task Force has added application material in ISA 540 (paragraph A158B) noting examples of requirements in ISA 540 (Revised), the documentation of which may provide evidence of the exercise of professional skepticism by the auditor.

**Matter for IAASB CAG Consideration**

4. The IAASB is asked for its views on the revised wording in paragraph 15 and related application material paragraph A92E, and on the proposed conforming amendment to paragraph A7 of ISA 230 (see **Agenda Item B.4**) and the related application material paragraph A158B in ISA 540 (Revised).

**Section II – Proposed ISA 540 (Revised) – Requirements**

31. Based on the comments received on the ED, numerous changes are proposed to the requirements and application material (see **Agenda Item B.2**). A high level overview of how the comments have been addressed is included in Appendix 2.

**Matter for IAASB CAG Consideration**

5. The IAASB CAG is asked for its views on the changes made to the requirements and application material of proposed ISA 540 (Revised), including the representatives' views on the revised documentation requirement? (Paragraph 27 of **Agenda Item B.2**)

**Section III – Conforming and Consequential Amendments**

**Conforming and Consequential Amendments to ISA 500<sup>7</sup>**

32. Generally, respondents were supportive of the proposed intent of the changes and enhanced focus on the consideration of the relevance and reliability of information obtained from an external information source (EIS). Comments received primarily focused on three topics: the proposed definition of EIS; proposed new application material in support of the amended requirement in paragraph 7 of the standard; and the linkage between proposed ISA 540 (Revised) and ISA 500.

*Definition of EIS*

33. The definition and related application material has been redrafted to remove reference to information being "publicly available" and instead has focused on the information being suitable for use by a broad range of users. In addition, the definition now explicitly removes service organizations, management's expert and auditor's experts from the definition of EIS when providing specific

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<sup>6</sup> ISA 230, *Audit Documentation*

<sup>7</sup> ISA 500, *Audit Evidence*

information in those capacities, to avoid confusion with those services for which ISA 402<sup>8</sup> or ISA 620<sup>9</sup> applies.

34. Changes were also made to the application material to better explain considerations, and provide examples, in distinguishing an EIS and management's expert.

#### *Application Material*

35. Based on suggestions from respondents, several changes to the application material were made, including:
- Reordering the content to improve the flow and readability;
  - Reflecting that the application material can be applied when management makes use of an EIS in preparing the financial statements and when an auditor independently obtains information from such a source to be used as audit evidence;
  - Further explaining relevant considerations and different approaches to considering the relevance and reliability of information from an EIS;
  - Clarifying the implications when there is only one source of information (and hence the auditor can only consider that source alone); and
  - Enhancing the guidance with respect to the implications of restricted access to evidence in relation to an EIS's information, or proprietary models, including the likely limitation on scope that results.

#### *Linkage between ISA 540 (Revised) and ISA 500*

36. Several respondents called for a more explicit linkage from ED-540 to the new application material in ISA 500 in respect of both information from an EIS and work of a management expert. Based on the comments received, a reference to ISA 500 with respect to the use of information from an EIS and information prepared using the work of a management's expert was added (paragraph 18D). In addition, the application material includes several references to ISA 500 and some proposed new paragraphs were moved from ISA 500 to ISA 540 (paragraph A134A-A134D).

#### **Conforming and Consequential Amendments to other ISAs**

37. Paragraph A95 of ED-540 referred to A42 of ISA 200 and noted the importance for the auditor's consideration of both inherent and control risk. Given comments from respondents the Task Force initially proposed to make a conforming amendment to paragraph A42 of ISA 200. However, the IAASB expressed concerns about confusion in the proposed wording, given that the ISAs do not ordinarily refer to inherent risk and control risk separately, but rather to a combined assessment of the risks of material misstatement. Although some Board members suggested that any change to ISA 200 should await deliberation as part of the ISA 315 project, the Board was supportive of addressing separate assessments of inherent and control risk more narrowly, in the context of accounting estimates, as this was within the scope of the ISA 540 project. Accordingly, the Task Force has changed the introduction of paragraph 13 to add an explicit requirement for the auditor to assess

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<sup>8</sup> ISA 402, *Audit Considerations Relating to an Entity Using a Service Organization*

<sup>9</sup> ISA 620, *Using the work of an auditor's expert*

inherent and control risk for accounting estimates and has proposed revised wording for the conforming amendment to paragraph A42 of ISA that reflects this new requirement.

38. As agreed by the Board in its December 2017 meeting, the accounting estimates section of Appendix 2 of ISA 260 (Revised)<sup>10</sup> was moved to Appendix 3 of proposed ISA 540 (Revised). The matters in Appendix 2 of ISA 260 (Revised) were merged with the matters that used to be included in paragraph A155 of ED-540.

**Matter for IAASB CAG Consideration**

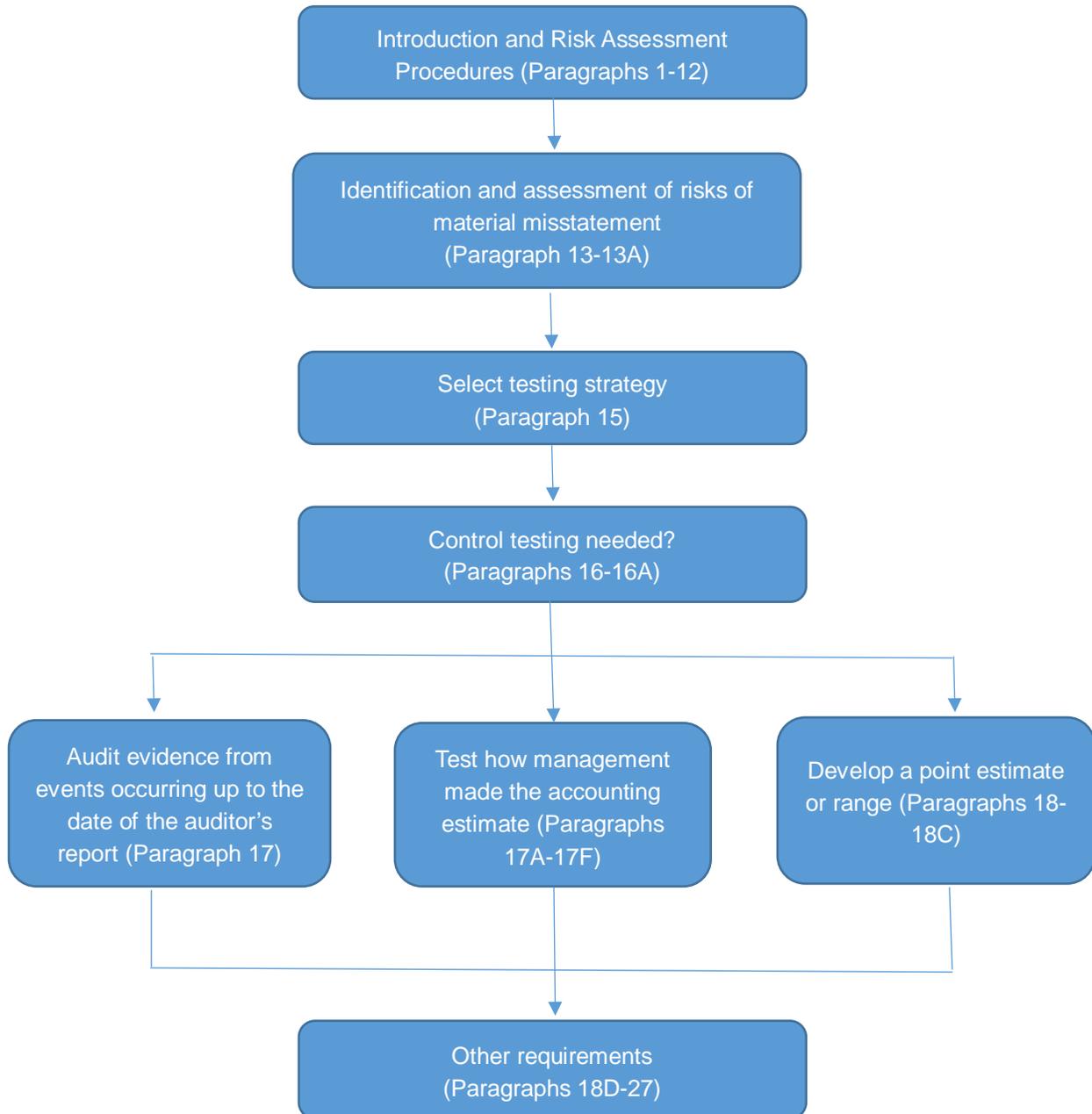
6. The IAASB CAG is asked for its views on the conforming and consequential amendments, specifically the proposed amendments to ISA 500 (see **Agenda Item B.4**).

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<sup>10</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

## Flow Chart of Restructured Work Effort Requirements

The inherent risk factors (including complexity, subjectivity and estimation uncertainty), as well as data, assumptions and methods, play a central role throughout the identification, assessment and response to the risks of material misstatement, including the selection of the testing strategy.



**Appendix 2**

**Discussion of Significant Matters from the Comment Letters and the Response**

Significant Matters from the Comment Letters	Response
<b>Paragraph 8 (Objective)</b>	
- The evaluation criterion for disclosures: “reasonable” or “adequate”	- The IAASB continues to support “reasonable” as the criterion for evaluating disclosures relating to accounting estimates.
- Consistent use of the terms ‘appropriate’, ‘adequate’, and ‘reasonable.’	- The Task Force will do a complete analysis of the use of these terms throughout the standard and conforming amendments.
<b>Paragraph 9 (Definitions)</b>	
- Definitions for <ul style="list-style-type: none"> <li>• Data or significant data;</li> <li>• Assumptions or significant assumptions;</li> <li>• Specialized skills and knowledge; and</li> <li>• Further audit procedures.</li> </ul>	- The IAASB does not support the addition of any new definitions. However, some of the descriptions of these concepts have been moved to the “Key Concepts” section of the ISA.
- All data would need to be considered, rather than just significant data.	- The IAASB continues to believe that the auditor should, in particular circumstances i.e., based on the reasons for the assessed risk of material misstatement, focus on significant data.
- The term ‘monetary amount’ in paragraph 9(a) should be removed.	- The IAASB continues to believe that the term ‘monetary amount’ is an essential part of the definition to avoid increasing the scope of the standard to cover estimates within estimates (for example, an estimate of useful life, which is treated as an assumption in the ED of proposed ISA 540 (Revised)). <sup>11</sup> (ED-540)
<b>Paragraph 10 (Risk Assessment Procedures)</b>	
- Clarifying the relationship with ISA 315 (Revised), including clarifying whether, and how,	- Changes were made to better align with ISA 315 (Revised), including the addition of subheadings within the requirement and paragraphs 10(d), (e) and (f) were integrated.

<sup>11</sup> Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

Significant Matters from the Comment Letters	Response
<p>paragraph 10 applies to estimates collectively or each estimate individually</p>	<p>- Regarding the ‘estimate’ vs. ‘estimates’ issue, the current draft has been aligned with ISA 315 (Revised) and 330, which leave this to the judgment of the auditor. These ISAs focus on, respectively, identifying and assessing the risks of material misstatement at the assertion level for classes of transactions, account balances and disclosures, and then responding to each assessed risk.</p>
<p>- Recognize the risk factors and reinforce the requirements regarding methods, assumptions, and data</p>	<p>- Changes were made to reinforce the requirement in this regard, and to reorganize relevant application material where necessary.</p>
<p>- Concerns about the overall clarity and length of the paragraph and related application material</p>	<p>- As noted above, changes were made to better align the requirement with ISA 315 (Revised) as this was the source of some of the concerns about the clarity and length of the requirements. The material was also reordered and simplified wording was used, where possible.</p>
<p><b>Paragraph 11 (Retrospective Review)</b></p>	
<p>- The retrospective review should apply to more than just the accounting estimates in the immediately preceding financial statements</p>	<p>- The IAASB has amended the requirement to address “previous accounting estimates.”</p>
<p>- Clarification of whether the paragraph was intended to apply to all estimates, or should be limited to a subset</p>	<p>- The IAASB noted that the paragraph already indicates that the nature and extent of the review takes into account the characteristics of the accounting estimate, and believed it was impractical to try to draw a bright line around a sub-set of accounting estimates that should be subject to retrospective view. Rather, the IAASB continues to believe that the scope of the review should be a matter of judgment, taking into account the characteristics of the accounting estimates in determining the nature and extent of the review – the application material provides further guidance in doing so.</p>
<p><b>Paragraphs 12 &amp; 14 (Specialized Skills and Knowledge)</b></p>	
<p>- Merge the two requirements into one overall requirement, or remove the requirement at the risk assessment stage</p>	<p>- Paragraphs 12 and 14 from ED-540 were merged into a single requirement.</p>

Significant Matters from the Comment Letters	Response
<b>Paragraph 13 (Identifying and Assessing the Risks of Material Misstatement)</b>	
<ul style="list-style-type: none"> <li>- Support for the three risk factors (complexity, judgment and estimation uncertainty).</li> </ul>	<ul style="list-style-type: none"> <li>- The IAASB is of the view that the inherent risk factors should be retained in the identification and assessment of the risks of material misstatement.</li> <li>- To align the risk factors with the proposals of the ISA 315 Task Force and the PCAOB's proposed standard, the factor 'judgment' was changed to 'subjectivity'.</li> <li>- In the introduction of paragraph 13 an explicit requirement was added for the auditor to assess inherent and control risk separately for accounting estimates. Also see paragraph 37 of the issues paper.</li> </ul>
<ul style="list-style-type: none"> <li>- Provide more prominence to the risk factor of estimation uncertainty as it influences the other factors</li> </ul>	<ul style="list-style-type: none"> <li>- In ED-540, the risk factors (complexity, judgment and estimation uncertainty) were included in a single list. In the revised version of ED-540, estimation uncertainty is included more prominently by separating the requirement to consider it (see paragraph 13(a)) from the requirement to consider the other risk factors (see paragraph 13(b)).</li> </ul>
<ul style="list-style-type: none"> <li>- Focus on the extent of the factors and not their existence given that the risk factors are present in all accounting estimates</li> </ul>	<ul style="list-style-type: none"> <li>- The need to consider the extent to which the risk factors affect susceptibility to misstatement is emphasized by adding 'the degree to which ...' before the risk factors.</li> </ul>
<ul style="list-style-type: none"> <li>- Place more emphasis on risk factors other than complexity, judgment and estimation uncertainty</li> </ul>	<ul style="list-style-type: none"> <li>- 'or other relevant factors' has been added to paragraph 13(b) and the rest of the standard aligned with this wording.</li> </ul>
<ul style="list-style-type: none"> <li>- Make a clearer link between paragraph 10 (risk assessment procedures) and the three risk factors in paragraph 13.</li> </ul>	<ul style="list-style-type: none"> <li>- The risk factors and references to methods, assumptions and data are included in both paragraphs.</li> </ul>
<b>Paragraph 13A (Determination of Significant Risks)</b>	
<ul style="list-style-type: none"> <li>- Improve the clarity and readability of the standard.</li> </ul>	<ul style="list-style-type: none"> <li>- To improve clarity and readability, the determination of whether any of the identified risks give rise to a significant risk was moved into a separate requirement; paragraph 13A. This wording was included in a single requirement in paragraph 13 of ED-540.</li> </ul>

Significant Matters from the Comment Letters	Response
<b>Paragraph 15 (Threshold and Testing Strategies)</b>	
<ul style="list-style-type: none"> <li>- Many respondents believed that ED-540 was sufficiently scalable, including indicating support for the use of a threshold as a way to drive scalability</li> <li>- Many other respondents expressed concerns about whether the structure of ED-540 would achieve the desired objective of scalability, including with regard to the threshold of “low inherent risk”</li> </ul>	<ul style="list-style-type: none"> <li>- The IAASB was of the view that the threshold could be removed and the scalability of ISA 540 can be emphasized in different ways. See Section I.</li> </ul>
<ul style="list-style-type: none"> <li>- Make the testing strategies for low inherent risk accounting estimates applicable to all accounting estimates, including those with an inherent risk that is not low.</li> </ul>	<ul style="list-style-type: none"> <li>- By changing the construct of paragraph 15, the IAASB has clarified the intent of ED-540 that the testing strategies are available for all accounting estimates. The testing strategies played a central role in extant ISA 540 as they also do in the PCAOB’s proposed standard on accounting estimates.</li> </ul>
<b>Paragraphs 16-16A (Tests of Controls)</b>	
<ul style="list-style-type: none"> <li>- General support for the requirement in paragraph 16 of ED-540</li> </ul>	<ul style="list-style-type: none"> <li>- Given the support for paragraph 16 in ED-540, the requirement has been retained and enhanced to respond to certain comments received. The following was added:                             <ul style="list-style-type: none"> <li>• The design and performance of tests of relevant controls shall be responsive to the reasons for the risks of material misstatement; and</li> <li>• The auditor shall take into account that the greater the reliance placed on the effectiveness of a control, the more persuasive the audit evidence needs to be.</li> </ul> </li> <li>- A new requirement (paragraph 16A) was added relating to testing relevant controls for a significant risk.</li> </ul>
<ul style="list-style-type: none"> <li>- Enhance the requirement and application material to better assist auditors in recognizing the circumstances in which, in</li> </ul>	<ul style="list-style-type: none"> <li>- In addition to the points above, the application material related to testing controls has been enhanced, including when testing relevant controls may be appropriate for certain types of estimates.</li> </ul>

Significant Matters from the Comment Letters	Response
<p>today’s environment, sufficient appropriate evidence cannot be obtained for the components of the estimate</p>	
<p><b>Paragraphs 17-19 (Responses to the Assessed Risks of Material Misstatement)</b></p>	
<p>- Concerns around the clarity, readability, operability of the standard</p>	<p>- The work effort is restructured around methods, assumptions and data rather than around the inherent risk factors as in ED-540.</p> <p>- Details about the restructuring are included below.</p>
<p>- Make the response to risks of material misstatement more intuitive for the auditor, as well as consistent with how management makes the estimate and how audit evidence is available, by describing relevant risk factors for an accounting estimate based on how they relate to the different components of the estimate (i.e. data, assumptions and methods/models);</p>	<p>- The response to the assessed risks of material misstatement is based around the testing strategy selected.</p> <p>- The following three testing strategies that were previously included in paragraph 15(a) of ED-540 are now included in paragraph 15, with separate objectives-based requirements for each of the testing strategies:</p> <ul style="list-style-type: none"> <li>• Determining whether events occurring up to the date of the auditor’s report provide audit evidence regarding the risks of material misstatement (paragraph 17);</li> <li>• Testing how management made the accounting estimate (paragraphs 17A-17F); and</li> <li>• Developing an auditor’s point estimate or range (paragraphs 18-18C) to evaluate management’s point estimate and related disclosures.</li> </ul> <p>- The objectives-based requirements that were included in paragraphs 17-20 in ED-540 are reorganized around each of the testing strategies and, where needed, new requirements were added.</p> <p>- Based on the comments received, a reference to ISA 500 with respect to the use of information from an EIS and information prepared using the work of a management’s expert were added (paragraph 18D).</p>
<p>- Make testing objectives in paragraph 17-20 available to all accounting estimates;</p>	<p>- The revisions to the requirement in paragraph 15 clarify that the testing strategies, and the related objectives-based requirements, are available for all accounting estimates.</p>
<p>- Make testing objectives in paragraph 17-20 available to</p>	<p>- See previous point.</p>

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<p>accounting estimates with low inherent risk.</p>	
<ul style="list-style-type: none"> <li>- Include subsequent events testing more prominently.</li> </ul>	<ul style="list-style-type: none"> <li>- Determining whether events occurring up to the date of the auditor’s report provides audit evidence regarding the risks of material misstatement has been given more prominence for all accounting estimates by including it as one of the testing approaches in paragraph 15.</li> </ul>
<p><b>Paragraph 19(b) (Development of an Auditor’s Point Estimate or Range)</b></p>	
<ul style="list-style-type: none"> <li>- Regarding paragraph 19(b), before developing an auditor’s point estimate or range when management has not appropriately understood and addressed the estimation uncertainty, require the auditor to first request management to consider alternative assumptions or provide additional disclosures relating to the estimation uncertainty (including whether paragraph A126 should be elevated to a requirement)</li> </ul>	<ul style="list-style-type: none"> <li>- Paragraph 17F addresses this point.</li> </ul>
<ul style="list-style-type: none"> <li>- Expand paragraph 19(b) and related application material to provide guidance on the auditor’s responsibility for evaluating the point in the range chosen by management, when management has developed a range within which an accounting estimate may reasonably fall.</li> </ul>	<ul style="list-style-type: none"> <li>- Application material was added to provide guidance on the auditor’s responsibility for evaluating the point in the range chosen by management.</li> </ul>
<ul style="list-style-type: none"> <li>- Concerns that paragraph 19(b) and related application material in paragraph A127 could lead to the auditor to assume the responsibilities of</li> </ul>	<ul style="list-style-type: none"> <li>- It was never the IAASB’s intention for the auditor to assume the responsibilities of management. This requirement originates from extant ISA 540 (paragraph 16). By including it under the testing strategy to test how management made the accounting estimate and providing additional application material (A126A and A126B),</li> </ul>

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management, or otherwise raise concerns about the auditor's independence.	the Task Force is of the view that the concerns are addressed.
<b>Paragraph 20 (The Auditor's Range)</b>	
<ul style="list-style-type: none"> <li>- General support for paragraph 20 of ED-540, along with the related application material</li> </ul>	<ul style="list-style-type: none"> <li>- Paragraph 20 of ED-540 is retained and included in the section that discusses the objectives-based requirements relating to the testing approach of developing an auditor's point estimate or range (see paragraph 18C).</li> <li>- As each section that addresses a testing strategy should stand on its own, the following was added: <ul style="list-style-type: none"> <li>• The auditor's range or point estimate should take into account the applicable financial reporting framework and the auditor's understanding of management's process to make the accounting estimate (paragraph 18).</li> <li>• Wording to paragraph 18A(a) to clarify that, when the auditor's point estimate or range is developed using the auditor's own methods, assumptions or data, the audit evidence to evaluate whether such methods, assumptions or data are appropriate includes evidence about the matters in paragraphs 17B-D, as applicable. The auditor also needs to consider the relevance and reliability of data obtained from an external information source (paragraph 18A(b)).</li> <li>• When the auditor uses management's methods, assumptions or data in developing an auditor's point estimate or range, a reference back to the objectives-based requirements relating to testing how management made the accounting estimate (paragraph 18B).</li> </ul> </li> </ul>
<ul style="list-style-type: none"> <li>- Clarify that paragraph 20 applies in all instances when the auditor concludes that it is appropriate to develop an auditor's range.</li> </ul>	<ul style="list-style-type: none"> <li>- This has been included as a separate requirement (see paragraph 18C) that would apply whenever the auditor's further auditor procedures in accordance with paragraph 15 include the approach of developing an auditor's point estimate or range.</li> </ul>
<b>Paragraph 21 (Disclosures)</b>	
<ul style="list-style-type: none"> <li>- General support for the enhanced disclosure requirement</li> </ul>	<ul style="list-style-type: none"> <li>- Some minor changes were made to paragraph 21 of ED-540 to address comments received on this paragraph.</li> </ul>

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<b>Paragraph 22 (Stand-Back)</b>	
<p>- Many respondents, including one Monitoring Group member, noted support for the various provisions of the stand-back requirement in paragraph 22. However, these respondents were also of the view that:</p> <ul style="list-style-type: none"> <li>• ED-540 should clarify whether the evaluation should be done at an individual estimate or overall level;</li> <li>• A more explicit requirement to consider ISA 705 (Revised)<sup>12</sup> in situations where the auditor is unable to obtain sufficient appropriate audit evidence should be included after paragraph 23.</li> </ul>	<p>- Regarding the 'estimate' vs. 'estimates' issue, the IAASB agreed with aligning it with ISA 330, which focuses on responding to each assessed risk of material misstatement, and therefore would apply to each accounting estimate.</p> <p>- The sentence addressing corroborative or contradictory evidence is combined with the sentence addressing the consequences of an inability to obtain sufficient appropriate audit evidence to give them greater prominence (see paragraph 22A)</p>
<b>Paragraph 23 (Misstatements)</b>	
<p>- Many respondents thought that paragraph 23 and the related application material will lead to a more consistent determination of a misstatement, but a few were opposed as they believe that the determination of materiality is open to interpretation and has not been sufficiently considered within ED-540, particularly for those misstatements that represent judgmental differences rather</p>	<p>- The IAASB agreed with respondents who supported paragraph 23, noting that this requirement was intended to follow from the requirement in paragraph 22, which is based on paragraphs 25 and 26 of ISA 330, which are performed at the assertion level. The Task Force is proposing that the requirement in paragraph 23 should be explicitly linked to the accounting estimates addressed in paragraph 22. Making the assessment at the assertion level does not mean that the auditor is expected to apply paragraph 23 to individual estimates but rather at the level of an assertion about a class of transactions account balance or disclosure. This does not, for example, require an auditor to determine separately the misstatement on each loan in a portfolio, when it would be more appropriate in the context of the requirements of the applicable financial reporting framework to identify assertions and</p>

<sup>12</sup> ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

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<p>than factual misstatements</p> <ul style="list-style-type: none"> <li>- Concerns about whether the requirement and application material dealt appropriately with disclosures.</li> </ul>	<p>misstatements at the level of a portfolio.</p>
<b>Paragraph 24 (Indicators of Possible Management Bias)</b>	
<ul style="list-style-type: none"> <li>- Move the requirement to identify indicators of potential management bias before the stand back requirement.</li> </ul>	<ul style="list-style-type: none"> <li>- The paragraph that requires the auditor to evaluate whether there are indicators of possible management bias moved before the stand back requirement.</li> </ul>
<ul style="list-style-type: none"> <li>- The term potential bias is too broad and there needs to be a qualifier to evaluate potential bias.</li> </ul>	<ul style="list-style-type: none"> <li>- The IAASB was of the view that a qualifier is not needed as it could limit the identification of indicators of management bias.</li> </ul>
<b>Paragraph 25 (Written Representations)</b>	
<ul style="list-style-type: none"> <li>- General support for the enhancements to paragraph 25</li> </ul>	<ul style="list-style-type: none"> <li>- Some changes were made to paragraph 25 of ED-540 to address comments received on this paragraph.</li> </ul>
<ul style="list-style-type: none"> <li>- Remove reference to 'reasonable' as it is more appropriate for management representations to address whether the relevant requirements of the applicable financial reporting framework have been appropriately applied in the preparation of the accounting estimates and the related disclosures.</li> </ul>	<ul style="list-style-type: none"> <li>- 'Reasonable in the context of the applicable financial reporting framework' is replaced with 'in accordance with the applicable financial reporting framework.' However, management representations would still address whether they believe the methods, assumptions and data used in making the accounting estimates are appropriate to achieve recognition, measurement or disclosure that is in accordance with the applicable financial reporting framework.</li> </ul>
<b>Paragraph 26 (Communication with Those Charged with Governance)</b>	
<ul style="list-style-type: none"> <li>- Support for including a requirement on communication with those charged with governance.</li> </ul>	<ul style="list-style-type: none"> <li>- The wording in paragraph 26 of ED-540 is aligned with the revised wording in paragraph 13 of Agenda Item B.2 relating to the risk factors.</li> <li>- As agreed by the Board in its December 2017 meeting, the Task Force moved the content relating to accounting estimates in Appendix 2 of ISA 260 (Revised) to Appendix 3 of proposed ISA 540</li> </ul>

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	(Revised). The Task Force merged the matters in Appendix 2 of ISA 260 (Revised) with the matters that were included in paragraph A155 of ED-540.
<b>Paragraph 27 (Documentation)</b>	
<p>- Clarify the expectations for documentation on the risk assessment procedures, the reasons for the assessed risk of material misstatement, the response to the assessed risk of material misstatement, the stand back, and the auditor's consideration of management bias.</p>	<p>- In response the Board's suggestion in the December 2017 IAASB meeting, the Task Force further considered the documentation requirements to respond to the significant comments by certain stakeholders. As a result the Task Force made the following changes:</p> <ul style="list-style-type: none"> <li>• Included sub bullet (a) (of the proposed ISA 540 (Revised) as shown to the Board in December 2017) to the introduction of the paragraph. The Task Force was of the view that this sub bullet was overarching and should therefore be included in the introduction.</li> <li>• Highlighted, in addition to management bias (which was included in sub bullet (b) of proposed ISA 540 (Revised) as shown to the Board in December 2017), four areas that the auditor should document: <ul style="list-style-type: none"> <li>○ Key elements of understanding of the entity and its environment and the system of internal control. This bullet is based on ISA 315 (Revised) paragraph 32(b).</li> <li>○ The reasons given to the separate assessments of inherent risk and control risk for the risks of material misstatement relating to accounting estimates.</li> <li>○ For accounting estimates subject to a greater degree of estimation uncertainty, or affected to a greater degree by subjectivity, complexity, or other inherent risk factors, the auditor's rationale for selecting one or more of the approaches to testing the accounting estimate. The Task Force was of the view that this is (i) an important consideration for the auditor to document and (ii) specific to auditing accounting estimates.</li> <li>○ The auditor's response when management has not appropriately understood and addressed estimation uncertainty. The Task Force was of the view that this is (i) an important consideration for the auditor to document and (ii) specific to auditing accounting estimates.</li> </ul> </li> </ul>