

Discussion of Changes to Requirements and Application Material

This paper explains the significant changes made by the ISA 540 Task Force (the Task Force) since the December 2017 IAASB Meeting for proposed ISA 540 (Revised)¹ and since the January 2018 IAASB Teleconference for the conforming and consequential amendments.

The IAASB is asked for its views on the changes discussed in this paper.

Reference	Rationale for Changes
Key Concepts of This ISA	
Paragraph 2A	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - A number of application material paragraphs that previously supported the requirement in paragraph 10 have been relocated to provide additional guidance on the first reference to methods, assumptions and data in the introduction to the standard (see paragraphs A1A-A1H).
Paragraph 3A	<ul style="list-style-type: none"> - This paragraph has been revised in response to comments made at the December 2017 IAASB meeting and discussions with the ISA 315 Task Force regarding the spectrum of inherent risk concept, but is subject to further revision as the ISA 315 Task Force further progresses its revisions to ISA 315 (Revised).² <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A1J: This paragraph has been relocated (previously A95) and updated to reflect comments on the proposed conforming amendment to paragraph A42 of ISA 200³ received on the January 30, 2018 IAASB teleconference.
Paragraph 6	<ul style="list-style-type: none"> - In response to comments received on ED-540, the Task Force has elevated the first set of bullets from paragraph A2 to provide additional context to the term ‘reasonable’ in the introduction to the standard.

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

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

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

Reference	Rationale for Changes
Effective Date	
Paragraph 7	- See Agenda Item 2 , Section 5.1.
Objective	
Paragraph 8	<ul style="list-style-type: none"> - In response to the comments made at the December 2017 IAASB meeting, the objective no longer refers to accounting estimates “including those required to be recognized or disclosed in the financial statements.” Instead, the definition of an accounting estimate (see paragraph 9(a)) now includes the wording “whether recognized or disclosed in the financial statements.” - As a result of this change, the Task Force has streamlined the wording of the objective, which also will help to avoid repeating “whether recognized or disclosed in the financial statements” throughout the standard.
Definitions	
Paragraph 9	<ul style="list-style-type: none"> - As noted above, the definition of an accounting estimate has been amended to include reference to a monetary amount “whether recognized or disclosed.” - In response to a comment at the December 2017 IAASB meeting about difficulties with perceived circularity, and in view of the change to the definition of an accounting estimate, the Task Force simplified the definition of estimation uncertainty.
Risk Assessment and Related Activities	
Paragraph 10	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - The Task Force has amended the lead-in text in response to comments received at the December 2017 IAASB meeting. The use of the term “to the degree relevant in the circumstances” is necessary to convey that, while all the provisions of paragraph 10 are relevant to some degree, in some audits individual provisions may be relevant to a greater or lesser degree. Application material (see paragraphs A8A and A10) have been drafted and amended, based on existing material, to provide guidance on how to apply paragraph 10 in a scalable manner.

Reference	Rationale for Changes
	<ul style="list-style-type: none"> - The Task Force has sought to reduce some repetition in the subparagraphs of paragraph 10. In particular, the Task Force has removed several references to “relevant to accounting estimates” as the wording “in relation to the entity’s accounting estimates” is contained in the lead-in. - Some subparagraphs of paragraph 10 have been relocated within the paragraph to improve the flow of the requirement and reduce repetition. To this end, paragraphs 10(g) and (h) have been combined, and paragraph 10(k) is now included in paragraph 10(i)(ii) - The Task Force discussed the importance of obtaining an understanding about relevant control activities, and has added an explicit requirement in paragraph 10(ia) for the auditor to obtain an understanding of the controls over management’s process for making accounting estimates. - The Task Force has retained the sub-headings in paragraph 10 based on the December IAASB discussion, which indicated that, on balance, board members preferred that the sub-headings be included. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A8A-A58D: This application material has been revised in accordance with the inventory shown to the IAASB at its December 2017 meeting (as updated) – meaning many of the paragraphs have been relocated or redrafted as matters for auditor consideration. Other changes include new material on the level of precision of control activities (see paragraph A58).
Identifying and Assessing the Risks of Material Misstatement	
Paragraph 13	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - In discussions about the proposed conforming amendment to paragraph A42 of ISA 200, 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 risk and control risk more narrowly, in the context of accounting estimates, 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 inherent and control risk separately for accounting estimates.

Reference	Rationale for Changes
	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A75A: The Task Force added this paragraph to highlight the importance of considering the precision of controls relied upon to assess control risk. - Paragraphs A75B, A79 and A82 and A83: The Task Force aligned the introduction of these paragraphs and recasted the introduction as matters that the auditors should take into account when assessing the risk of material misstatement related to the risk factors: estimation uncertainty, complexity and subjectivity. The Task Force also improved the flow of this section by merging some paragraphs. For example, paragraphs A79, A80 and A81, and A83 and A84.
Response to the Assessed Risk of Material Misstatement	
Paragraph 15	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - In the December 2017 IAASB meeting, the Board suggested further changes to paragraph 15 to avoid giving the impression that the auditor was expected to undertake a comprehensive search to obtain contradictory evidence. Therefore, the Task Force made changes to the last sentence of paragraph 15 and added new application material to explain the Task Force's intention. Also see Section 3 of Agenda Item 2. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A92E: The Task Force added this paragraph to help explain the intent of the last sentence of paragraph 15, which is to encourage an appropriate approach to designing further audit procedures that would not be biased in favor of seeking corroborating evidence when contradictory evidence might also be available from other relevant sources. Also see paragraphs 17-18 of Agenda Item 2. - Paragraph A94: The Task Force included a paragraph on scalability, which is partly based on A94E and A94F as presented to the Board in December 2017, that highlights how proposed ISA 540 (Revised) is scalable for simpler accounting estimates. The Task Force was of the view that such a paragraph would be more useful than the 'considerations for smaller entities' paragraphs as it focusses on the risks related to an accounting estimate rather than the size of the entity; smaller entities can also have complex accounting estimates and complex entities also have simple accounting estimates.

Reference	Rationale for Changes
Paragraph 16	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A97B: The Task Force added this paragraph as a response to calls from stakeholders to describe factors that the auditor may take into account when reaching a decision about the nature, timing and extent of testing of controls. This paragraph was originally included in IAPN 1000⁴ and has been modified to work in the context of accounting estimates.
<i>Determining Whether Events Occurring up to the Date of the Auditor's Report Provide Audit Evidence Regarding the Accounting Estimate</i>	
Paragraph 17	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs 100A-100F: These paragraphs were included in the draft of ISA 540 presented to the Board in December and are based on paragraphs A62-A67 of extant ISA 540.⁵ The Task Force has updated these paragraphs to better explain when this approach may be an appropriate response, and to explain that it may be necessary to use this approach in connection with another testing strategy in paragraph 15.
<i>Testing How Management Made the Accounting Estimate</i>	
Paragraph 17A	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - A100G is based on paragraph A68 from extant ISA 540. The Task Force is of the view that the paragraph will help auditors determine which approach may be an appropriate response in certain circumstances. Similar paragraphs are included for the other testing strategies -- paragraph 100A (Events occurring up to the date of the auditor's report) and paragraph A126C (Developing an auditor's point estimate or using an auditor's range).
Paragraph 17B	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - The Task Force has aligned the structure of this paragraph with paragraphs 17C and 17D.

⁴ International Auditing Practice Note (IAPN) 1000, *Special Considerations in Auditing Financial Instruments*

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

Reference	Rationale for Changes
	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A108E: The Task Force added this paragraph as some respondents to the exposure draft noted that the term ‘data integrity’ was not clear.
Paragraph 17E	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - The Task Force added the words “in the context of the applicable financial reporting framework” to paragraph 17E(b) to be consistent with the change made to paragraph 18C (see below). <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A116-A120. The Task Force merged paragraphs A116 and A119 and changed the paragraphs to describe relevant considerations for the auditor regarding the reasonableness of management’s point estimate. Similarly, paragraph A120 was recast to describe matters that the financial reporting framework describes that the auditor may take into account.
Paragraph 17F	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - The Task Force made changes to improve the flow of this paragraph. For example: <ul style="list-style-type: none"> • Changed the order of the sub-requirements to put 17F(c) first. This was done in response to comments that, when management has not appropriately understood and addressed the estimation uncertainty, the auditor would always need to evaluate whether a deficiency in internal control exists. The first sentence of paragraph of 17F(c) was deleted as it was repetitive of wording in the lead-in to this paragraph. • Revised paragraph 17F(a) by referring the auditor back to the previous requirement (paragraph 17E) to evaluate management’s response when management has considered alternative assumptions or performed a sensitivity analysis, or provided additional disclosures. • Clarified the lead-in wording to paragraph 17F(b) to indicate that the requirement applies if the auditor determines that management’s response to the auditor’s request is inadequate. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A126A-A126B: The Task Force added paragraphs A126A and A126B as a response to some

Reference	Rationale for Changes
	<p>respondents to the ED who noted that, when the auditor prepares a range when management hasn't appropriately understood or addressed estimation uncertainty, it may present an independence issue.</p>
<p><i>Developing an Auditor's Point Estimate or Range Based on Available Audit Evidence to Evaluate Management's Point Estimate and Related Disclosures About Estimation Uncertainty</i></p>	
<p>Paragraphs 18-18C</p>	<p><i>Requirements</i></p> <ul style="list-style-type: none"> - The Task Force added 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 Task Force changed the structure of paragraph 18C as follows: <ul style="list-style-type: none"> • Retained the requirement from paragraph 20 ED-540 that, when the auditor develops a range, the auditor is required to determine that all amounts included in the range are supported by sufficient appropriate audit evidence and have been evaluated to be reasonable in the context of the measurement objectives and other requirements of the applicable financial reporting framework. • Added a requirement, consistent with paragraph 17E(b) when the auditor is testing how management made the accounting estimate, for the auditor to determine that management's point estimate, and the disclosures in the financial statements that describe the estimation uncertainty, are reasonable in the context of the applicable financial reporting framework. This helps to clarify that, regardless of the testing approach selected, the auditor needs to evaluate the entire depiction of the accounting estimate for inclusion in the financial statements (i.e., both the selection of management's point estimate and disclosures that describe the estimation uncertainty). <p><i>Application Material</i></p> <ul style="list-style-type: none"> - The Task Force revised paragraphs A126C-A129B to address comments received on ED-540 asking for more guidance on when developing an auditor's point estimate or range may be an appropriate response (including reinstating points from paragraph A87 of extant ISA 540), as well as when the auditor may decide to develop a point estimate rather than a range.

Reference	Rationale for Changes
	<ul style="list-style-type: none"> - Paragraph A134 was revised in response to specific points raised by respondents to ED -540.
Other Considerations Relating to Audit Evidence	
Paragraphs 18D and E	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - To improve the flow of the standard, the Task Force merged the paragraphs (paragraph 18D and 18E) that directed the auditor to ISA 500⁶ when information is used from an external information source (EIS) or if information is prepared using the work of a management's expert.
Disclosures	
Paragraph 21	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A135-A138A: The Task Force re-ordered the application material related to disclosures: <ul style="list-style-type: none"> • Paragraphs that were educational in style (paragraph A136 and A137) were moved to appendix 1; and • Paragraphs that relate to disclosures generally are included as application to paragraph 21, while paragraphs that relate to disclosures related to estimation uncertainty are included in the application material to paragraph 17F.
Management Bias	
Paragraph 21A	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A138B-A138E: The Task Force re-ordered the application material related to paragraph 21A. Otherwise no significant changes made.

⁶ ISA 500, *Audit Evidence*

Overall Evaluation Based on Audit Procedures Performed	
Paragraph 23	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - The Task Force has added introductory wording that links to paragraph 22 to clarify that the requirement applies to each accounting estimate. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A142: The Task Force deleted this paragraph as the key concept has been elevated to paragraph 23. - Paragraphs A143–A143A: These paragraphs have been redrafted to improve readability. The paragraphs now commence with the simplest situation (no misstatement) and then proceed to discuss different possible scenarios in a logical order.
Communication with Those Charged with Governance	
Paragraph 26	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A155: As agreed by the Board in its December 2017 meeting, the Task Force moved the matters that the auditor may consider in communicating to those charged with governance (that used to be included in A155 of ED-540) to Appendix 3. - Appendix 3: 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)⁷ to Appendix 3 of proposed ISA 540 (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.
Documentation	
Paragraph 27	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - 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,

⁷ ISA 260 (Revised), *Communication with Those Charged with Governance*

the Task Force made the following changes:

- Moved 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.
- 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:
 - 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).
 - The reasons given to the separate assessments of inherent risk and control risk for the risks of material misstatement relating to accounting estimates.
 - 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.
 - 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.

Application Material

- Paragraph A158A: In response the Board's suggestion in the December 2017 IAASB meeting, the Task Force added, in addition to the changes to paragraph 27, paragraph A158A. This paragraph includes additional matters that the auditor may document when a complex model is used to make the accounting estimate.
- Paragraph A158B: The Task Force added this paragraph to build on, and support the proposed conforming amendment to paragraph 7 of ISA 230⁸ by providing examples of requirements in ISA 540 (Revised) for which documentation in support of the requirement may provide evidence of the exercise of professional skepticism by the auditor.

⁸ ISA 230, Audit Documentation

Conforming and Consequential Amendments	
ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing	
Paragraph A42	- In response to comments from the Board on the January 30, 2018 teleconference, the Task Force removed the “Ordinarily, therefore” wording and changed the order of the second and third sentences. This is intended to make it clearer that, although the ISAs do not ordinarily refer to separate assessments of inherent and control risk, ISA 540 (Revised) requires a separate assessment of inherent and control risk for accounting estimates.
ISA 230, Audit Documentation	
Paragraph A7	- Addition to give emphasis to the importance of documenting evidence of the exercise of professional skepticism when auditing accounting estimates, when they are subject to greater estimation uncertainty or are affected to a greater degree by complexity or subjectivity.
Paragraph A10	- The Board questioned the consistency with paragraph 23 of ISA 540 in relation to the singular or plural reference to estimates. After additional consideration by the Task Force, paragraph 23 has been amended to indicate that it is based on the auditor's evaluation in paragraph 22.
ISA 260 (Revised), Communication with Those Charged with Governance	
Paragraph A20	- The Board continued to have concerns that the application material was inconsistent with the language and intent of the requirement (paragraph 16). The language has been amended to more closely mirror the requirement and reference to “suitable” removed.

ISA 500, Audit Evidence	
<i>Definition</i>	
Paragraph 5(cA)	<p><i>Definition of External Information Source</i></p> <ul style="list-style-type: none"> - The definition has been simplified (but as a result lengthened) based on suggestions from Board members. The hanging paragraph addressing exclusions from the definition has been replaced with a more explicit second sentence. - The Task Force considered the question of when a management’s expert makes use of an EIS but believes trying to include this concept in the definition would add unwarranted complexity. The Task Force has proposed a further amendment to paragraph A48 (see below) to draw attention to the potential need to consider a management’s expert’s use of an EIS. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraphs A1A and A1Aa: Deletion of content adding no incremental guidance beyond what is stated in the definition. Redrafting to make the intent clearer and further minor changes to ensure consistency of terminology across the application material. - Paragraph A1C: Some Board members raised questions over the role of a service organization and whether the ISA was seeking to address a service organization’s use of an EIS. The intent of the Task Force was not to seek to address that question. The inclusion of reference to a service organization in the definition was merely seeking to exclude information provided to the entity in its capacity as the entity’s service organization. The addition to paragraph A1C seeks to make this clear. - Paragraph A1Ca: Final two bullets redrafted and shortened based on various suggestions from Board members. Additional changes to address consistency of language across all bullets.
<i>Requirement and related Application Material</i>	
Paragraph 6	<p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A9: A question was raised as to whether analyst’ reports and benchmarking data, as referred to in paragraph A9, could be considered information from an EIS. The Task Force agrees that they could and has

	restructured the sentence accordingly.
Paragraph 7	<p><i>Requirement</i></p> <ul style="list-style-type: none"> - A couple of Board members reiterated a request for the addition to the end of paragraph 7 to be deleted on the basis that it is redundant, as the definition of audit evidence already includes all potential sources of such evidence. This question was raised with the Board at the December 2017 meeting and, following discussion, the addition to paragraph 7 was retained for the reason that additional emphasis on information from an EIS was useful in the requirements section. The Task Force continues to support this decision and believes that moving consideration of EIS to a separate stand-alone requirement would not address the underlying concern expressed. <p><i>Application Material</i></p> <ul style="list-style-type: none"> - Paragraph A26: Board members supported relocating this paragraph to later in the standard. However, on reflection the Task Force has deleted as it does not add anything incremental to the definition or requirement 7. - Paragraph A33F: Some Board members expressed concerns about the implied need for, and practicality of, some of the further audit procedures described. The Task Force has added introductory language to provide additional context for the phrase “when relevant” i.e., when the auditor considers them appropriate in the circumstances (possible, not mandated approaches) and by including reference back to the reasons for the assessed risk of material misstatement. The first bullet (performing testing at the EIS) has been relocated to the last bullet to reduce any implied perception that this is the “preferred” approach. - Paragraph A48: A number of Board members raised management’s expert’s use of an EIS as a relevant consideration. The Task Force agrees that this is relevant but should be considered as part of the auditor’s overall evaluation of the appropriateness of the work of the management’s expert in accordance with paragraph 8. An additional bullet has been added to highlight the potential need to consider the relevance and reliability of information from an external source.