Agenda Item 2-D

Note to IAASB: This document is Appendix 4 to draft ISA 540 (Revised). It is intended to be included in the final standard.

Appendix 4

Examples to Illustrate Scalability

1. The purpose of this Appendix is to illustrate how the requirements in ISA 540 (Revised) are scalable for different entities with accounting estimates with different characteristics.

2. This ISA is scalable for accounting estimates with differing risks of material misstatement, including those that give rise only to lower risks of material misstatement, for example:

   a) For a fixed asset with commonly accepted useful life, the auditor may determine that the appropriate approach is to develop a range using management's methods and data, but to use the auditor's own assumptions. In such a case, obtaining sufficient appropriate audit evidence may be straightforward as the variation in reasonably possible assumptions for useful lives is likely to be limited.

   b) For an accrual, if the audit evidence does not involve information from an external information source or information prepared using the work of a management's expert, then paragraph 18D is not relevant for that accounting estimate.

3. Two examples are provided below of a similar account balance that requires estimation, to show how different facts and circumstances may affect the auditor's risk assessment procedures (i.e., understanding of the entity and its environment and the system of internal control), identification and assessment of the risks of material misstatement, and responses to those risks.

   The examples below focus only on the valuation assertion and are neither intended to be a comprehensive explanation of the requirements of ISA 540, nor intended to indicate the most appropriate approach to testing the accounting estimate in the circumstances.

Example 1 – Simple Bonus Accrual	**Example 2 – Complex Bonus Accrual**
• The financial statements are prepared by management of the entity in accordance with IFRS (a general purpose framework). • Entity operates in a single industry, with no relevant regulatory factors. • The entity's bonus scheme is set by management with criteria that allows limited scope for judgment and is payable in cash. The bonus is based on the achievement of sales targets after taking into account rebates paid after year end (i.e., the criteria). • The entity is unlisted. Management does not consider that specialized skills or knowledge are necessary. The bonuses are paid out shortly after the year end.	• The financial statements are prepared by management of the entity in accordance with IFRS (a general purpose framework). • The entity operates in a regulated industry, with a number of regulatory factors that may increase the complexity of management's process for making the accounting estimate. • The entity has a complex bonus scheme that awards employees cash-settled stock options based on comparing a series of performance measures that involve subjective judgments against specified performance benchmarks. The options are granted at an exercise price that is at a discount to the fair value of the options on the date of grant, and the options are subject to differing vesting conditions (both market-based and non-market-based). • The entity is listed but there is only limited market information relevant to the fair value of the options. Accordingly, management uses internal and external information and external experts in calculating the fair value of the options. The bonuses are expected to be paid out after the auditor's report is issued.

Example 1 – Simple Bonus Accrual	Example 2 – Complex Bonus Accrual
Obtaining an Understanding of the Entity and Its Environment (Paragraph 10-12)	
• The auditor's inquiries of management reveal that the process for determining the bonus accrual is not complex. • The entity has a limited, informal risk assessment process and has not identified the bonus accrual as a significant area of risk. • Due to the simplicity of the process, only management review controls have been implemented. • The auditor reviews the outcome of the most recent bonus accrual and notes that the amounts paid agree with the amount accrued at the end of the prior period. • The auditor determines that specialized skills or knowledge are not needed for the audit team.	• The auditor's inquiries of management reveal that the process for valuing the employee stock options is complex (using a complex model). Accordingly, the auditor performs walkthroughs of relevant systems, interviews employees involved, and obtains an understanding of the design and implementation of relevant controls over the determination of the bonus accrual. • The entity has an extensive risk assessment process that takes into account the risks associated with the employee stock options. • Management has established specific controls over the employee stock options. The auditor determines that these controls are relevant to the audit and evaluates their design and implementation. • The auditor reviews the outcome of previous bonus accruals to evaluate how successful management has been at valuing the bonus accrual in the past. The auditor does this over several financial reporting periods to take into account vesting conditions that extend over those periods. The auditor notes that management has a track record of not making significant errors in estimating the bonus accrual in the past. • The auditor determines that, due to the complexity of the entity's process and nature of the measurement basis, and the risk of management bias, specialized skills or knowledge are required to identify and assess the risks of material misstatement and to design and perform audit procedures.

<table>
<tr><th colspan="2">Identification and Assessment of Risk of Material Misstatements</th></tr>
<tr><td>• The auditor assesses that there is a lower risk of material misstatement related to the valuation assertion for the bonus accrual.</td><td>• The auditor assesses that there is a higher risk of material misstatement related to the valuation assertion for the bonus accrual.</td></tr>
<tr><td>• The following inherent risk factors were taken into account by the auditor:
o Estimation uncertainty: The bonus accrual is subject to a low degree of estimation uncertainty because the amounts can be measured with a high degree of precision based on the criteria.
o Complexity: There is a low degree of complexity in the selection of the method, assumptions and data.data. Subjectivityty: The valuation of the bonuses may be affected by a misjudgment by management as to the amount of bonus payable, pending resolution of the uncertainties regarding the rebates paid after year end, but the effect on susceptibility to misstatement is considered to be relatively low.</td><td>• The following inherent risk factors were taken into account by the auditor:
o Estimation uncertainty: The applicable financial reporting framework requires the use of a method that inherently has a high level of estimation uncertainty and uses many assumptions that are based on limited available data.
o Complexity: The method is complex and therefore the process of maintaining, testing, controlling, and operating the model is complex. Multiple sources of data (including from external information sources) are processed through the entity's information system in making the accounting estimate.
o Subjectivity: The bonus accrual requires management to use judgment to select methods, assumptions, and data.</td></tr>
<tr><th colspan="2">Response</th></tr>
<tr><td colspan="2">Strategy(ies) Selected</td></tr>
<tr><td>• The auditor determines that the appropriate approach is to obtain audit evidence about events occurring up to the date of the auditor's report as the bonuses are paid out shortly after period end. The auditor also determines that a wholly substantive approach will provide sufficient appropriate audit evidence and therefore it is not</td><td>• The auditor determines that the appropriate approach is to test how management made the accounting estimate, including testing the operating effectiveness of controls.
• The auditor considers that this is an appropriate strategy in the circumstances because other strategies are unlikely to provide sufficient appropriate audit evidence about the valuation assertion. This is because:
o It is not possible to obtain relevant audit evidence by testing subsequent payments; and</td></tr>
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<tr><td>necessary to test the operating effectiveness of controls.
The auditor considers that this is an appropriate strategy in the circumstances because sufficient appropriate audit evidence can be obtained about management’s judgments regarding the rebates paid after year-end through the subsequent payment of the bonus and reviewing the supporting documentation.</td><td><li style="list-style-type: circle">The auditor believes it would be impractical to develop an auditor’s range or point estimate as it would require duplicating complex management information systems.</td></tr>
<tr><td colspan="2" align="center">Responses to the Assessed Risk of Material Misstatement</td></tr>
<tr><td>The auditor obtains audit evidence about events occurring up to the date of the auditor’s report, including information about the sales targets and the supporting documentation regarding the rebates paid after year-end.</td><td>The following is a selection of possible responses to the assessed risk of material misstatement. Additional or alternative procedures may be needed to comply with paragraphs 17B–17F.

Method
The auditor obtains audit evidence about the appropriateness of management’s method, including about changes from the prior period.
With respect to the complex model, the auditor, with the assistance of an auditor’s expert, obtains audit evidence about the model’s design, including changes from the previous period.
Significant Assumptions
The auditor, with the assistance of an auditor’s expert, obtains audit evidence about the significant assumptions. The auditor’s procedures are focused on whether the assumptions selected by management are appropriate in the context of the applicable financial reporting framework and whether there are indicators of management bias in the selection of the assumptions.
Significant Data
The auditor obtains audit evidence about the significant data relating to the bonus accrual, particularly those aspects that are most subject to judgment such as vesting conditions.</td></tr>
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	Management's understanding of estimation uncertainty • The auditor obtains audit evidence about how management understood the effect of estimation uncertainty on the range of possible measurement outcomes Selection of a Point Estimate and Related Disclosures • The auditor reviews management's basis for selection of management's point estimate and the related disclosures and obtains audit evidence to determine whether they are reasonable. External Information Source • To enable the auditor to consider the relevance and reliability of the external information source, the auditor obtains relevant information about the reputation of, about the entity's relationships with, and about the basis on which the information was prepared by, the external information source • The auditor considers whether there are opportunities for management to influence the information obtained and the appropriateness of the basis on which the information was prepared. • After considering these and other matters, the auditor compares a selection of information obtained from the external information source with information obtained from an alternative external information source. Controls • For controls relevant to the valuation assertion, the auditor designs and performs tests of the operating effectiveness of relevant controls.