

## Proposed ISA 540 (Revised)<sup>1</sup>—Issues Paper

### Objectives of Agenda Item

The objectives of this agenda item are:

1. To consider the ISA 540 Task Force's proposed revisions to ISA 540 (Revised) and to the conforming and consequential amendments to other ISAs.
2. To determine whether there are any other matters relating to proposed ISA 540 (Revised) that the IAASB believes needs to be discussed before the standard is finalized as expected in June 2018.

### 1. Introduction and Overview of Agenda Items

1. Since the December 2017 IAASB meeting, the ISA 540 Task Force (the Task Force) has focused on progressing the draft of proposed ISA 540 (Revised), in particular the restructuring and redrafting of the application material, as well as revising the conforming and consequential amendments to address comments from the January 30, 2018 IAASB teleconference. This issues paper explains how the Task Force has further considered and addressed the following key issues:
  - Scalability (See Section 2);
  - Professional skepticism (See Section 3);
  - Application material and appendices (See Section 4); and
  - Other matters (See Section 5).
2. The Task Force has developed a series of additional papers to support the discussion at the March 2018 IAASB meeting. These papers are as follows:
  - Agenda Item 2-A: Discussion of Changes to the Requirement and Application Material;
  - Agenda Item 2-B: Draft Proposed ISA 540 (Revised) – Marked from December 2017 IAASB Meeting;
  - Agenda Item 2-C: Proposed ISA 540 (Revised) – Clean;
  - Agenda Item 2-D: Appendix 4 of Proposed ISA 540 (Revised);
  - Agenda Item 2-E: Draft Conforming and Consequential Amendments – Marked from January 2018 IAASB Teleconference; and
  - Agenda Item 2-F: Conforming and Consequential Amendments – Clean.
3. The Task Force will use **Agenda Item 2-C** as the basis for the discussion of the requirements and the application material. The Task Force believes that the Board will benefit from reading the clean version due to the nature of the revisions (in particular, the significant amount of restructuring and relocation of application material paragraphs). However, **Agenda Item 2-B** may be useful in understanding the changes from the agenda material discussed during the December 2017 meeting. The Task Force will use **Agenda Item 2-E** as the basis for the discussion of the conforming and consequential amendments.

<sup>1</sup> Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

## 2. Scalability

4. 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 Exposure Draft (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).
5. As discussed with the IAASB in December 2017, 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”);
  - Recognizing the spectrum of risk concept, building on existing concepts in ISA 200,<sup>2</sup> ISA 315 (Revised),<sup>3</sup> and ISA 330,<sup>4</sup> and aligning with the direction of the ISA 315 Task Force (see 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; 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.

### 2.1 Scalability in the Requirements and Application Material

6. In its discussions and revisions to proposed ISA 540 since the December 2017 meeting, one of the priorities of the Task Force has been to address scalability in the requirements and application material, considering the options discussed above. In particular, the Task Force has looked to provide wording and examples in the 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 such material under a separate “Scalability” sub-heading or merged it with other relevant application material.
7. Specific paragraphs of the application material that address scalability include, for example:
  - 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

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<sup>2</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>3</sup> ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

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

- A94, relating to the nature, timing and extent of the auditor's further audit procedures.
8. In other places, the Task Force believes the scalability will be self-evident based on the conditionality of the requirement (e.g., “to the degree relevant in the circumstances” in paragraph 10) or the absence of the circumstance in the case of a particular entity (e.g., paragraph A10A would not apply for entities that do not have an internal audit function).

## 2.2 Additional Scalability Example(s)

9. Another option discussed with the IAASB in December 2017 was 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 as noted in paragraph 4 above.
10. Accordingly, the Task Force has developed an example (see **Agenda Item 2-D**) to illustrate the scalability in the requirements in paragraphs 10 through 18D for a straightforward cash bonus accrual and a more complex share-based payment arrangement. The Task Force proposes to include this as Appendix 4 to proposed ISA 540 (Revised) to be responsive to the calls from respondents to ED-540 for additional examples of scalability.

## 2.3 Continued Liaison with the ISA 315 Task Force

11. The Task Force continues to coordinate 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 inherent risk concept. The Task Force believes that the discussion in the draft of ISA 540 (Revised) of inherent risk factors, and the requirement to obtain an understanding of the entity and its environment and the system of internal control in relation to the entity's accounting estimates, is appropriately aligned with the direction of the ISA 315 Task Force.
12. The Task Force also recognizes that the spectrum of risk concept will need to be clearly explained and supported by examples. The Task Force has continued to liaise with the ISA 315 Task Force to understand the changes being proposed to ISA 315 (Revised) in this regard, and to align the wording in ISA 540 (Revised) to be consistent with the discussion of the related concepts in ISA 315 (Revised). Accordingly, application material has been added to **Agenda Item 2** (see paragraphs A11–A10) to describe the spectrum of inherent risk, and the spectrum of risks of material misstatement, in the context of existing concepts in ISA 200. These paragraphs have been taken from a preliminary draft of the ISA 315 agenda material. They will be discussed in connection with **Agenda Item 3-A**, and changes resulting from that discussion will be reflected in ISA 540 (Revised) to keep them consistent with the application material in the draft of ISA 315 (Revised). Paragraphs 3A and A71 of ISA 540 (Revised) have been updated accordingly.
13. A joint Task Force meeting is planned during the March 2018 IAASB meeting.

### Matters for IAASB Consideration

The IAASB is asked for its views on:

1. The way that scalability is introduced and demonstrated in the requirements and application material (**Agenda Item 2-B**).
2. The detailed example of scalability in proposed Appendix 4 (**Agenda Item 2-D**).

### 3. Professional Skepticism

14. Based on the preliminary analysis of comments to ED-540, 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. (See Supplement B to Agenda Item 2 for the October 2017 meeting.) 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.
15. The Task Force has continued to discuss ways to address specific comments received regarding the importance of the effective exercise of professional skepticism 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.
16. In December 2017, the Task Force discussed with the IAASB proposed wording to paragraph 15 of ISA 540 intended to drive actions that are more likely to ensure that the auditor seeks audit evidence from relevant sources, even if that evidence may be contradictory. Based on input from the IAASB and additional Task Force discussion, the Task Force has further revised the wording in paragraph 15 of **Agenda Item 2-B** as follows:

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. The auditor shall design the further audit procedures to seek ~~sufficient appropriate~~ audit evidence from relevant sources, regardless of whether such audit evidence ~~would~~ is evaluated to be corroborative or contradictory.

17. 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 been 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.
18. 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.
19. 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 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 and is proposing a conforming amendment to paragraph A7 of ISA 230.<sup>5</sup> See additional discussion in **Agenda Items 2-A**. In addition, to build on and support this proposed amendment,

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<sup>5</sup> ISA 230, Audit Documentation

the Task Force has added application material (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 Consideration**

3. 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 2-E**) and the related application material paragraph A158B in ISA 540 (Revised).

#### **4. Application Material and Appendices**

20. Many comments were received on the application material in the responses to ED-540, both positive and negative, including a significant number of suggestions for restructuring the application material. 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.

##### **4.1 Analysis and Review of the Application Material**

21. The Task Force identified possible ways to address the application material in ED-540 through performing a comprehensive analysis and review of respondents' comments. The primary purpose of the analysis and review, beyond understanding the extent and nature of the comments, was to consider how to modify and restructure the application material in ED-540 in response to the comments and restructuring suggestions received to make it more effective in the final revised standard.
22. The Task Force recognized that the changes to the application material as a result of the proposed restructuring of the requirements, as well as other changes to the application material, could be complex, with potentially several reasons for considering changes to particular application material paragraphs. As a result, the Task Force discussed with the IAASB in December 2017, and has followed, a carefully coordinated and controlled approach to making the changes to the application material (see section 5 of Agenda Item 2 for the December 2017 IAASB meeting).

##### **4.2 Revisions to the Application Material**

23. Subsequent to the December 2017 IAASB meeting, the Task Force has further analyzed, reviewed and discussed the application material, with a view to clarifying and restructuring it to:
  - Delete or re-purpose material that was considered to be educational in style, or repetitive of guidance in other ISAs;
  - 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.
24. As discussed with the IAASB in December, a significant number of comments were received asking for additional guidance or examples, particularly with respect to audits for small and medium 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.
25. 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 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.

#### 4.3 Revisions to the Appendices

26. Some comments were received on the appendices<sup>6</sup> and the Task Force discussed how best to respond to these comments, particularly the requests for additional explanation of the inter-relationship among the inherent risk factors.
27. The Task Force noted that very few comments were received on Appendix 1 and 2 of ED-540. Some respondents suggested that one or both of the appendices should be deleted while other respondents supported the appendices. Other comments from respondents to ED-540 indicated a desire for additional explanation of the inter-relationship among the inherent risk factors. Accordingly, the Task Force concluded that the appendices should be retained and redrafted to address the comments received.
28. Appendix 1 has been updated to provide clarifications and strengthen the integration with Appendix 2, particularly with respect to the application of measurement techniques and valuation attributes in making an accounting estimate. In addition, several paragraphs of application material from ED-540 were moved to Appendix 1 as the Task Force determined that they were more educational in nature but nonetheless helpful material relevant to the subject matter of that Appendix.
29. 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;
  - The nature of inherent risk in making an accounting estimate, and what gives rise to inherent risk; and
  - How estimation uncertainty relates to subjectivity (including management judgments) and complexity in making accounting estimates.

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

The Board is asked for its views on whether:

4. The restructured and redrafted application material is clear and understandable, and

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<sup>6</sup> See paragraph 34 of the analysis of the general comments received on ED-540 at:  
[www.iaasb.org/system/files/meetings/files/20171211-IAASB\\_Agenda\\_Item\\_2-F.6-Analysis\\_General\\_Comments.pdf](http://www.iaasb.org/system/files/meetings/files/20171211-IAASB_Agenda_Item_2-F.6-Analysis_General_Comments.pdf)

- appropriately supports the application of the related requirements;
5. The changes to the appendices are helpful, and whether the cross-references between the appendices and the requirements and application material help to support integration of the appendices and the standard.
  6. There are any other matters relating to proposed ISA 540 (Revised) that need to be discussed before the standard is finalized as expected in June 2018.

## 5. Other Matters

### 5.1 Effective Date

30. As noted in Agenda Item 2-F.5 for the December 2017 meeting,<sup>7</sup> a majority of respondents were supportive of the proposed 18-month transition period from the date of approval of a final ISA.
31. The Task Force is proposing that the effective date of a final ISA 540 (Revised) be for audits of financial statements for periods ending on or after December 15, 2019, with early adoption permitted. In discussing the proposed effective date, the Task Force focused on the public interest need to balance the speed of adoption of the strengthened ISA (particularly in light of the impending mandatory effective date of IFRS 9<sup>8</sup> (annual periods beginning on or after January 1, 2018) and other standards (e.g., IFRS 15),<sup>9</sup> with the need to allow adequate time for translation, training and methodology changes.

### 5.2 Conforming and Consequential Amendments

32. The Task Force has considered the comments from the Board on the January 30, 2018 IAASB teleconference and has made appropriate revisions to the consequential amendments to ISA 500.<sup>10</sup> Significant changes made by the Task Force are summarized in **Agenda Item 2-A. Agenda Items 2-E and 2-F** (marked and clean versions, respectively) include the details of the conforming and consequential amendments to ISA 500 and other ISAs.

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<sup>7</sup> [http://www.iaasb.org/system/files/meetings/files/20171211-IAASB\\_Agenda\\_Item\\_2-F.5-Analysis\\_Question\\_8.pdf](http://www.iaasb.org/system/files/meetings/files/20171211-IAASB_Agenda_Item_2-F.5-Analysis_Question_8.pdf)

<sup>8</sup> International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

<sup>9</sup> IFRS 15, *Revenue from Contracts with Customers*

<sup>10</sup> ISA 500, *Audit Evidence*

## 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 stakeholders 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 Task Force has held one physical meeting and three teleconference since the January 2018 IAASB teleconference.
3. The leadership of the Task Force met once with the leadership of the ISA 315 Task Force since the January 2018 IAASB teleconference.

#### Outreach

4. The leadership of the Task Force has had teleconferences and meetings with representatives of the:
  - Basel Committee on Banking Supervision;
  - International Forum of Independent Audit Regulators; and
  - International Federation of Accountants' Small and Medium Practices Committee.
5. Between the posting of the papers and the March 2018 Board meeting the leadership of the Task Force will have teleconferences with representatives of:
  - International Association of Insurance Supervisors; and
  - Global Public Policy Committee.
6. On March 6, 2018 the leadership of the Task Force will meet with the IAASB's Consultative Advisory Group.
7. Further outreach will be scheduled with key stakeholders to discuss the draft version of proposed ISA 540 (Revised).

## Appendix B

### Draft Minutes of the December 2017 Board Meeting<sup>11</sup>

#### Draft ISA 540 (Revised)<sup>12</sup>

Messrs. Sharko and Grabowski introduced the topic. The IAASB discussed key issues raised by respondents, including the scalability of the ISA, the use of the term “reasonable,” the exercise of professional skepticism and the proposed approach to responding to comments on the application material. The IAASB also discussed the Task Force’s revisions to requirements and application material. During the meeting, revised requirements were presented to the IAASB.

#### KEY ISSUES

In response to the key issues identified in **Agenda Item 2-A**, the Board:

- Supported the Task Force’s direction with respect to scalability generally, and specifically the use of the spectrum of risk and the approaches as described **Agenda Item 2-A** to demonstrate scalability. With respect to the use of the spectrum of risk, the Board encouraged the ISA 315 (Revised) Task Force and ISA 540 Task Force to keep working together to make sure the standards are aligned. The Board also noted the importance of including examples to demonstrate the scalability of the standard.
- Supported the direction of the ISA 540 Task Force to eliminate the threshold of low/not low inherent risk.
- Expressed mixed views about whether “reasonable” is the appropriate criterion for both the accounting estimate and related disclosures.
- Suggested further changes to paragraph 15 to better convey that the auditor should not disregard contradictory evidence but that the auditor was not expected to seek out contradictory evidence.
- Supported the Task Force’s proposed approach to the application material.

#### DRAFT ISA 540 (REVISED)

The Board discussed **Agenda Item 2-B**, and an updated version which included revisions made during the Board meeting. Other than editorial and minor drafting suggestions, the Board agreed with the Task Force’s proposals except as noted below:

- The key concepts section needs to be clearer, and sections regarding the spectrum of inherent risk need to be aligned with the description in draft proposed ISA 315 (Revised).
- The Task Force should consider whether further changes are needed to the objectives.
- In relation to paragraph 10, the Task Force should further align the lead in text with the latest proposals of the ISA 315 (Revised).<sup>13</sup> It was also noted that further refinement of the sub-bullets is needed to make clear what incremental risk assessment is needed for accounting estimates, beyond that in ISA 315 (Revised). The Task Force was also asked to clarify the scalability of paragraph 10.

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<sup>11</sup> Draft minutes of the January 2018 IAASB meeting will be circulated prior to the March 2018 IAASB meeting.

<sup>12</sup> Draft ISA 540 (Revised), *Accounting Estimates and Related Disclosures*

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

- The Task Force should consider clarifying when the auditor would be required to take more than one reporting period into account in performing a retrospective review
- The Task Force should prepare a comparison of the work effort requirements in proposed ISA 540 (Revised) with the PCAOB's proposals.
- Paragraphs 15 and 16 should be aligned further with ISA 330.<sup>14</sup>
- Paragraphs related to the use of information from an external information source (paragraph 17E) and a management's expert (paragraph 17F) should be moved to a separate heading within the work effort section.
- The Task Force should further consider the documentation requirements to respond to the significant comments by certain stakeholders.

#### CONFORMING AMENDMENTS

In relation to the conforming amendments to ISA 500,<sup>15</sup> the IAASB:

- Requested that the conforming amendments be provided in the context of the whole of ISA 500.
- Asked the Task Force to consider whether the application material in ISA 500 implies a greater work effort than is required by paragraph 7 of ISA 500.
- Asked the Task Force to determine whether some of the application material proposed for inclusion in ISA 500 would be more appropriately placed in ISA 540.
- Noted that ISA 500 also needed to provide guidance on the auditor's use of an external information source.

In relation to other conforming amendments, the IAASB:

- Did not support adding the term 'further audit procedures' to the glossary.
- Did not support the conforming amendments to ISA 200<sup>16</sup> that removed the reference to a combined assessment of inherent and control risk as commentators have not had the opportunity to comment on it. Instead, the Board suggested including guidance in ISA 540 (Revised) about the need for a separate assessment of inherent and control risk.
- Requested that relevant sections of Appendix 2 of ISA 260 (Revised)<sup>17</sup> be included in ISA 540 (Revised) so that ISA 540 (Revised) provides a comprehensive listing of matters related to accounting estimates that may be communicated to those charged with governance.
- Asked the Task Force to consider whether to clarify the application material in ISA 260 regarding the auditor's actions when a significant accounting practice that is acceptable under the applicable financial reporting framework but is not the most appropriate to the particular circumstances of the entity.

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<sup>14</sup> ISA 330, *The Auditor's Responses to Assessed Risks*

<sup>15</sup> ISA 500, *Audit Evidence*

<sup>16</sup> ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

<sup>17</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

#### IAASB CAG CHAIR'S REMARKS

Mr. Dalkin noted that the informal call with interested CAG representatives had been a success. He noted that the CAG was interested in seeing that the standard used terms such as “reasonable” consistently throughout. He also noted that the CAG was focused on incorporating discussion of professional skepticism into the discussions on ISA 540, and the discussions around contradictory evidence were useful in this regard.

#### PIOB OBSERVER REMARKS

Ms. Stothers noted the importance of the Board's consideration of the requests from key stakeholder for elevations of application material to the requirements. She also noted that the documentation requirements and associated guidance material were a key focus area for audit inspectors.

#### WAY FORWARD

The IAASB asked the Task Force to focus on redrafting the application material according to the planned approach with a view to conducting a first read of ISA 540 (Revised) in March 2018, ahead of a targeted approval in June 2018.