

Task Force Analysis of Due Process Related to Re-Exposure**Overview**

1. If the Board votes to approve proposed ISA 540 (Revised),¹ then a separate affirmative vote of the Board is required on whether the ISA should be re-exposed. Based on the changes proposed in **Agenda Item 2-B**, and prior to any changes proposed at the June 2018 IAASB meeting, the Task Force unanimously believes that proposed ISA 540 (Revised) should not be re-exposed.
2. This paper sets out the Task Force's analysis of the provisions of the due process related to whether an approved ISA needs to be re-exposed.

What Does the Due Process Require?

3. Appendix A includes relevant extracts from the IAASB's due process. The principal consideration in the due process is "whether there has been substantial change to the exposed document such that re-exposure is necessary." The related working procedures, which support the due process, include three examples of situations that may constitute potential grounds for a decision to re-expose:
 - (a) Substantial change to a proposal arising from matters not aired in the exposure draft (ED) such that commentators have not had an opportunity to make their views known to the IAASB before it reaches a final conclusion;
 - (b) Substantial change arising from matters not previously deliberated by the IAASB; or
 - (c) Substantial change to the substance of a proposed international pronouncement.

Considerations Relevant to the Development of the Task Force's View on Re-Exposure

4. The key elements addressed in the version of Exposure Draft of ISA 540 (Revised) (ED-540) are highlighted in the Explanatory Memorandum to ED-540. These included:
 - (a) Modernizing the ISA for an evolving business environment by recognizing the increased use of modelling, forward-looking assumptions, and external information sources;
 - (b) Reinforcing professional skepticism through enhanced risk assessment requirements, more granular work effort requirements, and the requirement to "stand back" and evaluate the audit evidence obtained;
 - (c) Clarifying the need for, and meaning of, the term "reasonable" and its application to management's point estimate and related disclosures;
 - (d) The use of inherent risk factors in identifying and assessing the risks of material misstatement for accounting estimates;
 - (e) A more rigorous work effort that builds on the inherent risk factors, is scalable, and requires the further audit procedures to be responsive to the reasons for the assessment given to the risk of material misstatement, and reinforces the need to test the operating effectiveness of controls in certain circumstances. ED-540 also proposed a change from "narrowing" the auditor's range

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

to only including in the range amounts that are supported by audit evidence and that the auditor has evaluated to be reasonable in the context of the applicable financial reporting framework.

- (f) A broader approach to disclosures for all accounting estimates. In particular, emphasizing the importance of disclosures about estimation uncertainty for all accounting estimates rather than only those that give rise to significant risks; and
 - (g) Conforming amendments to various ISAs to support the changes proposed to ISA 540. Of particular note were the changes to ISA 500² regarding external information sources.
5. While the key elements identified in paragraph 4 have been retained, some of these elements have been modified and clarified in response to comments received on exposure, in arriving at the draft presented for discussion at the June 2018 IAASB meeting. The Task Force notes that there will almost always be changes to standards between an ED and final standard – and this is true for proposed ISA 540 (Revised). However, these changes have not altered the key elements of the proposed revised ISA, nor have they resulted in a departure from the objectives of the revision.
 6. Although these key elements have not fundamentally changed, the Task Force considered the nature and extent of the changes made since ED-540 to evaluate whether those changes are of such that re-exposure is necessary.
 7. To facilitate both the Task Force's and the Board's consideration of the changes since ED-540, **Agenda Item 2-G** compares the requirements in ED-540 with **Agenda Item 2-C** and includes:
 - (a) An analysis of the nature of the changes; and
 - (b) Color-coding to show where key phrases in paragraphs 10 and 17–20 from ED-540 have been relocated within those paragraphs, but where the intent is nonetheless the same.
 8. The Task Force notes the following changes from ED-540:
 - (a) Paragraph 12 of **Agenda Item 2-B** (Paragraph 10 of ED-540)

The IAASB received comments on exposure that paragraph 10 of ED-540 was not easily scalable for smaller/less complex audits, which may not have any complex, subjective accounting estimates with a higher degree of estimation uncertainty. Respondents also commented that certain sub-paragraphs of ED-540, particularly 10(f), did not set a clear expectation for the auditor and were concerned that paragraph 10 did not align with ISA 315 (Revised).³

In response, the Task Force made the following revisions:

- Amended the lead-in and drafted application material to clarify how the requirements can be applied in a scalable manner;
- Reorganized and revised the wording of the individual sub-bullets, and integrated paragraph 10(f) of ED-540 with other sub-paragraphs that related to management's actions so that the IAASB's expectations would be clear, and

² ISA 500, *Audit Evidence*

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

- Made further changes to align with ISA 315 (Revised), including re-purposing sub-bullets to align with the components of internal control. In particular, the term used to describe the inherent risk factor of “judgment” was changed to “subjectivity.”

The approach in paragraph 12 of **Agenda Item 2-B** has been clarified and better aligned with ISA 315 (Revised) but is not fundamentally changed from that in ED-540.

(b) Paragraph 15 of **Agenda Item 2-B** (Paragraph 13 of ED-540)

The IAASB received comments on exposure that paragraph 13 of ED-540 should be structured around the elements of the process for making accounting estimates (methods, assumptions, data) while retaining the emphasis on considering the inherent risk factors. In addition, respondents to ED-540 generally supported the focus on inherent risk factors and the auditor’s consideration of inherent risk when identifying, assessing and responding to the risks of material misstatement for accounting estimates.

In response, the Task Force made the following revisions:

- Required a separate assessment of inherent and control risk for accounting estimates. In the course of the IAASB’s deliberations following ED-540, it became clear that an explicit separate assessment of inherent risk was appropriate to drive the necessary focus by auditors on the consideration of inherent risk factors in identifying and assessing risks of material misstatement. Respondents to ED-540 acknowledged the importance of the auditor’s consideration of inherent risk factors in identifying and assessing risks of material misstatement, including significant risks, at the assertion level and in designing and performing further audit procedures to respond to those assessed risks. The requirement for a separate assessment of inherent risk in proposed ISA 540 (Revised) further highlights this by focusing on a spectrum of inherent risk, consistent with existing concepts in ISA 200,⁴ and acknowledging that inherent risk varies on a scale and can be assessed at the lower or higher end of the spectrum.

The Task Force notes that paragraph 7 of ISA 330⁵ requires the auditor to consider both inherent risk and control risk in designing the further audit procedures to be performed. The Task Force further notes that, consistent with the points discussed above, the project to revise ISA 315 (Revised) proposes to require separate assessments of inherent risk and control risk in assessing the risks of material misstatement at the assertion level, more broadly than for risks relating to accounting estimates.

- Aligned the risk factors with the proposed changes to ISA 315 (Revised), while maintaining alignment with extant ISA 315 (Revised), and the U.S. Public Company Accounting Oversight Board proposed standard.⁶
- Amended paragraph 15 of **Agenda Item 2-B** to clarify that, in assessing inherent risk, the auditor takes into account the degree to which the accounting estimate is subject to estimation uncertainty, and the degree to which the selection and application of the methods, assumptions and data used in making the accounting estimates, and the

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

⁵ ISA 330, *The Auditor’s Responses to Assessed Risks*

⁶ pcaobus.org/Rulemaking/Docket043/2017-002-auditing-accounting-estimates-proposed-rule.pdf

selection of management's point estimate and related disclosures for inclusion in the financial statements, are affected by complexity, subjectivity, or other inherent risk factors.

- Made further changes to improve the flow between paragraphs 12, 15, and the work effort requirements of **Agenda Item 2-B**.

The Task Force also has proposed a conforming amendment to paragraph A42 of ISA 200 to acknowledge the separate assessments of inherent and control risk for accounting estimates. Although some board members suggested that any change to ISA 200 should await deliberation as part of the ISA 315 project, the IAASB 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.

(c) Paragraph 17 of **Agenda Item 2-B**

While supportive comments were received on the threshold of low/not low inherent risk, the IAASB also received comments expressing concerns that the threshold was seen to be complex, difficult to operationalize, perceived to be inconsistent with ISA 315 (Revised), and may not assist in driving the scalability that is desired. There were also calls for the work effort to be based on the testing strategies in extant ISA 540,⁷ and to include the testing strategies in the requirements as they were not seen to be sufficiently prominent as application material in ED-540. Respondents also noted that references to the need for application of professional skepticism should be more prominent in the revised standard, including in this paragraph (or elsewhere earlier in the requirements) to drive appropriate auditor behavior.

In light of these comments:

- The Task Force amended paragraph 17 of **Agenda Item 2-B** to remove the threshold approach, but kept the focus on scalability by retaining the requirement for the auditor's further audit procedures to be responsive to the assessed risks of material misstatement, considering the reasons given to those risks.
- Paragraph 17 of **Agenda Item 2-B** now also serves as a signpost to the three testing strategies and provides the structure for the objectives-based requirements in paragraphs 20–28 of **Agenda Item 2-B**.
- Paragraph 17 of **Agenda Item 2-B** also enhances professional skepticism by requiring explicitly that the audit evidence needs to be obtained in a manner that is neither biased towards obtaining audit evidence that may be corroborative nor biased towards not obtaining audit evidence that may be contradictory.

(d) Paragraphs 20-28 of **Agenda Item 2-B**

Respondents to ED-540 noted that the structure of the work effort paragraphs was unclear, complex, too granular/prescriptive, and not intuitive. Comments also were received that the testing objectives in paragraphs 17–20 of ED-540 may also be applicable for estimates with low inherent risk and that certain of those testing objectives are not always related to a single risk factor (e.g., certain testing objectives for complexity may also be applicable for judgment).

⁷ Extant ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

In light of these comments, the Task Force more closely aligned the work effort requirements around the way accounting estimates are made (that is, methods, assumptions and data) and with how extant ISA 540 is structured. This resulted in changes to the structure and order of the work effort requirements. The Task Force believes that the requirements in this section are sufficiently objectives-based and that no further changes were necessary in this regard. The color coding in **Agenda Item 2-G** shows that the underlying objectives-based requirements are consistent with those in ED-540 (that is, the IAASB's expectations for the work that should be performed have not changed significantly).

(e) Paragraph 37 of **Agenda Item 2-B**

Some respondents to ED-540 asked for more specificity in the documentation requirements to clarify the IAASB's expectations and to drive more consistent documentation practices.

In light of these comments, the Task Force included additional detail in the documentation requirements, including requirements to document:

- Key elements of the auditor's understanding of the entity and its environment, including the entity's internal control related to the entity's accounting estimates;
- The linkage of the auditor's further audit procedures with the assessed risks of material misstatement at the assertion level; and
- Significant professional judgments relating to the auditor's determination of whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated.

The Task Force believes that appropriate application of ISA 230⁸ would already result in these matters being documented.

Task Force Views on Whether the Changes Necessitate Re-Exposure

9. The Task Force has analyzed the relevant due process requirements and made the following observations:
- (a) Have the key elements of the ISA changed, or have the objectives of the project changed? While there have been many changes to the ISA, the key elements of ED-540 have been retained but modified and clarified in response to comments received on exposure as noted in paragraph 5 above. In addition, the Task Force believes that the changes made since ED-540 do not change the objectives of the revision of ISA 540.
 - (b) Have new concepts been introduced? The Task Force considered the changes from ED-540 and determined that two key concepts could be seen by some as "new": (i) how the work effort was made scalable to different accounting estimates; and (ii) the organization of the work effort into the testing strategies. The Task Force concluded that these concepts were already in ED-540 in one form or another:
 - i. The use of inherent risk as a threshold to drive a scalable work effort has been removed, but scalability is still maintained through the focus on the spectrum of inherent risk and

⁸ ISA 230, *Audit Documentation*

the requirement, consistent with ISA 330, for the auditor's further audit procedures to be responsive to the assessed risks of material misstatement.

- ii. The inherent risk factors were used as the structure for ED-540's objectives-based requirements in the work effort section. The focus on the risk factors has been retained, but the work effort section is now re-organized around the testing strategies and methods, assumptions and data in response to comments on exposure. The Task Force noted that the structure used in the June 2018 agenda material restructures the objectives-based requirements from ED-540 into the testing strategies around which extant ISA 540 is structured, so concluded that no new concepts had been introduced.
 - (c) Has there been adequate opportunity for the IAASB to be informed of stakeholder views before the IAASB reaches a final conclusion? The Task Force noted that there have been 24 targeted outreach activities since ED-540 was issued.⁹ The IAASB Consultative Advisory Group (CAG) has had a series of informal teleconferences outside of the regularly scheduled in-person meetings to inform the Task Force and the IAASB of views that may be held by different stakeholder groups. On balance, the Task Force does not believe that the IAASB needs further consultation to more fully understand stakeholder views.
10. The Task Force also considered whether there were other relevant factors that could be taken into account in determining whether re-exposure is necessary. These included:
- (a) The public interest considerations in delaying improvements to audits of accounting estimates, including the urgency of the need for changes and the additional steps taken by the Task Force to consult since ED-540; and
 - (b) Whether the IAASB will become aware of any new concerns by re-exposing ISA 540.¹⁰
11. The Task Force believes that re-exposing proposed ISA 540 (Revised) will not result in new information or concerns that have not been aired already through the comment letters on ED-540 or the subsequent outreach and consultation activities. The Task Force also notes that re-exposure of proposed ISA 540 (Revised) would delay the implementation of ISA 540 (Revised) significantly, which would be contrary to the public interest in driving improvements in auditing accounting estimates at the earliest practical opportunity.

Implementation Recommendations

12. The Task Force recognizes that the changes proposed in Agenda Item 2-B do not eliminate all implementation challenges that would have arisen from the implementation of ED-540. While the Task Force does not believe these challenges are a reason for re-exposure, the Task Force believes that they give rise to a need for a strategic approach to implementation support, specifically:
- (a) The establishment of an implementation working group to provide a resource to respond to practical challenges encountered in the implementation of the revised ISA;

⁹ A listing of outreach activities specific to ISA 540 is included in Appendix B. By way of information, this is a relevant factor for the IASB in deciding whether to re-expose a standard. See paragraph 6.27 of their Due Process Handbook (www.ifrs.org/-/media/feature/about-us/legal-and-governance/constitution-docs/due-process-handbook.pdf).

¹⁰ By way of information, this is a relevant factor for the IASB in deciding whether to re-expose a standard. See paragraph 6.26 of their Due Process Handbook.

- (b) The issuance of additional non-authoritative guidance material, including (a) re-purposing former Appendix 1 (Measurement Bases of Accounting Estimates) and proposed Appendix 4 presented to the IAASB in March 2018 (examples to illustrate scalability), which were removed from the draft standard based on the IAASB discussion in March 2018; and (b) flowcharts illustrating the flow of the requirements of the revised standard and relationship to other ISAs (e.g., ISA 315 (Revised) and 330).
- (c) A post-implementation review of ISA 540 two to three years after the effective date of the ISA.

Appendix A

Relevant Extracts from the IAASB's Due Process

The IAASB's Due Process is available on the IAASB's website.¹¹ The relevant material is paragraph 23 and A40–A42.

23. After approving the final revised content of an exposed international pronouncement, the PIAC¹² votes on whether there has been substantial change to the exposed document such that re-exposure is necessary. An affirmative vote in accordance with the PIAC's terms of reference that re-exposure is necessary is required to issue a re-exposure draft. The basis of the PIAC's decisions with respect to re-exposure is recorded in the minutes of the PIAC meeting at which the related project is discussed. (Ref: Para. A40-A42)

...

Re-Exposure (Ref: Para. 23)

- A40. When an exposure draft has been subject to many changes, a summary comparative analysis is presented to the PIAC. This analysis shows, to the extent practicable, the differences between the exposure draft and the proposed final international pronouncement.
- A41. The senior staff member of the PIAC, in consultation with the Chair of the PIAC and chair of the Project Task Force, advises the PIAC on whether a draft international pronouncement, or part thereof, needs to be re-exposed.
- A42. Situations that constitute potential grounds for a decision to re-expose may include, for example: substantial change to a proposal arising from matters not aired in the exposure draft such that commentators have not had an opportunity to make their views known to the PIAC before it reaches a final conclusion; substantial change arising from matters not previously deliberated by the PIAC; or substantial change to the substance of a proposed international pronouncement.

¹¹ www.ifac.org/system/files/uploads/PIAC-Due_Process_and_Working_Procedures.pdf

¹² Public Interest Activity Committee, i.e. the IAASB.

Appendix B

Outreach and Consultation Activities Since the Release of ED-540

The Task Force met with representatives or staff of the following stakeholders since the release of ED-540 (As of May 30th, 2018):

Q2 2017

1. Forum of Firms
2. Crowe Horwath International
3. Basel Committee on Banking Supervision's Accounting Expert Group
4. Independent Regulatory Board for Auditors of South Africa
5. Financial Stability Board's External Audit Roundtable
6. International Association of Insurance Supervisors' Accounting and Auditing Working Group

Q3 2017

7. Royal Netherlands Institute of Chartered Accountants
8. Office of the Superintendent of Financial Institutions Canada

Q4 2017

9. Global Public Policy Committee
10. Basel Committee on Banking Supervision's Auditing Sub Group
11. Committee of European Auditing Oversight Bodies' Inspection Sub-Group and International Auditing Standards Sub-Group
12. U.S. Public Company Accounting Oversight Board
13. International Organization of Securities Commissions' Committee 1, Auditing Subcommittee
14. International Valuation Standards Council

Q1 2018

15. Basel Committee on Banking Supervision Audit Sub Group
16. American Institute of Certified Public Accountants Auditing Standards Board
17. Basel Committee on Banking Supervision's Accounting Expert Group
18. International Forum of Independent Audit Regulators' Standards Coordination Working Group
19. International Federation of Accountants' Small and Medium Practices Committee
20. International Association of Insurance Supervisors' Accounting and Auditing Working Group
21. Global Public Policy Committee.
22. International Forum of Independent Audit Regulators' Standards Coordination Working Group

Q2 2018

23. U.S. Public Company Accounting Oversight Board
24. International Organization of Securities Commissions' Committee 1, Auditing Subcommittee

The Task Force also met three times with the IAASB CAG:

1. September 2017 IAASB CAG meeting;
2. December 2017 informal call; and
3. March 2018 IAASB CAG meeting.