Responses to specific questions on Exposure Draft of ISA 540

MEMBERS OF THE NEW DELHI EXPERT GROUP TO FORMULATE COMMENTS ED OF ISA 540R – INDIA

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1. Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?

1.1 Given the need for the ISA to remain framework neutral, it is challenging to include very specific requirements linked to a specific framework. However, in our view the changes made address important concepts that are common to financial reporting frameworks, including a heightened focus on data, assumptions and disclosures.

1.2 In thinking about evolving financial reporting framework requirements and whether the ISA addresses relevant considerations, it is also critical to consider expectations of users, including regulators, about what is needed to comply with those financial reporting requirements, in particular disclosures. We believe that the proposed additions to the requirements proposed in the ED, specifically the greater granularity of the matters about which the auditor is required to obtain audit evidence, is a useful stepforward in addressing the aforesaid issue

2. Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?

2.1 We support the need to ensure that the Standard provides a strong foundation that supports the appropriate application of professional skepticism. Evaluating the relevance, reliability and sufficiency of evidence and providing robust challenge to management in the areas of subjective judgement are critical elements in auditing accounting estimates. That is best achieved through the nature of the requirements rather than statements that remind or reinforce the importance of the concept.

2.2 We believe that the revised requirements in the proposed Revised ISA 540 will encourage a more detailed understanding of how accounting estimates are determined by management. That, alongside the requirements on identification, assessment and response to risk will, in our view, focus the auditor to think more about the reasons for the assessment given to risks of material misstatement and where audit procedures need to be targeted to obtain sufficient appropriate audit evidence.

2.3 We also support the additional focus on consideration of management bias and the proposed stand-back evaluation to assess the sufficiency of evidence obtained.

3. Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?

3.1 We recognise the need to better articulate how the requirements of ISA 540 can be applied in a scalable manner to the very broad range of estimates that fall within the scope of the Standard. We also acknowledge that many audits of financial statements of smaller entities will often consist of “simpler” estimates. However, it is important that the ISA focuses on the nature of the estimates and not the size of the entity being audited, as even smaller entities will often have more complex estimates.

3.2 It is not clear whether the “low risk” would apply at the ROMM level or at the assertion level. Further, would it apply to all estimates or all risks attached with every estimate. This needs to be clarified.

3.3 We suggest that the application material could better illustrate scalability in responding to assessed risks through providing further explanation and examples about what may be involved in obtaining sufficient appropriate audit evidence for simpler accounting estimates. For example, in relation to a non-complex (or “simple”) estimate, how events occurring up to the date of the auditor’s report may provide robust evidence about the estimate. Or, if testing management process, how re-performing a simple straight forward calculation, such as depreciation, or an analytical procedure to develop a point estimate for a simple, straightforward calculation, such as a payroll expense, may be appropriate.

3.4 Recognising that risks exist along a spectrum, we believe it is preferable to reinforce the principle, as set out in the second part of paragraph 15, that the higher the assessed risk the more persuasive the audit evidence needs to be. This could be brought to life in examples within the application material.

3.5 We also believe that a more prominent focus on testing events subsequent to the balance sheet date, when those provide sufficient appropriate audit evidence, would boost the perception of scalability.

4. When inherent risk is not low (see paragraphs 13, 15 and 17–20):

a) Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?

b) Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?

c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?

4.1 We support many of the concepts and related guidance that have been incorporated, which we believe will promote a more granular consideration of the nature and extent of what can go wrong, to inform the auditor's risk assessment at the assertion level and design appropriate responses. That includes thinking about how complexity, the need for judgement and estimation uncertainty can influence the assessment of identified risks (e.g., whether the risk of misstatement at the assertion level is low, or higher, or a significant risk) and how best to design further audit procedures to obtain evidence in response to the risk. We agree that these were important things to think about.

4.2 The factors are, however, not "what can go wrong" i.e., the estimate is not misstated because it is complex or needs judgement. We continue to believe that identifying and evaluating the risk of material misstatement for account balances, classes of transactions, and disclosures at the assertion level remains appropriate. The assertions identified in ISA 315 (e.g., existence, completeness, accuracy and valuation etc.) are the ways in which an account balance can be misstated.

4.3 We are therefore concerned that the way in which paragraph 13 is drafted and, more specifically, the fact that the related response to risk requirements (paragraphs 17-19) are driven by each factor creates an artificial structure for designing an appropriate response to identified risks and is not straightforward to apply in practice. We also believe there is a risk of unintended consequences that in focusing on factors and obtaining evidence about "matters", there is the potential that the auditor might not adequately address the risk of material misstatement at the assertion level – i.e., it could drive a checklist approach to simply performing procedures without properly evaluating whether those procedures, and evidence obtained, provide sufficient appropriate audit evidence about the specific risks of material misstatement at the assertion level that have been identified.

4.4 There is a perceived need to put each identified risk in a "bucket", when they are not mutually exclusive, and also confusion over which factors, individually or in combination, were applicable as "the reasons for the assessment given to the risk". This could lead to a complicated documentation "matrix" – mapping identified risks to specific risk factors and relevant assertions, which we are not sure was the intent and which we believe will cause confusion and will not add value to either the auditor's risk assessment or design of responses.

4.5 The following challenges in applying the new requirements are identified:

4.5.i The focus on factors may result in the broader understanding of the entity in ISA 315, as supplemented by paragraph 10 of ISA 540, being overshadowed. There is no clear linkage in paragraph 13 back to paragraph 10 and the list of matters about which the auditor had to obtain an understanding over to help inform their risk assessment.

4.5. ii The structure of the requirements on responding to assessed risks is not intuitive and there is a clear perception of a failure to explain how to address inter-relationships between the factors. For example, the extensive overlap between paragraphs 17 and 18 gives rise to confusion. The distinction between, for example, paragraph 17(a) and paragraph 18(a)(i) is not clear.

4.5. iii There is also confusion over why items are listed under certain factors. For example, there are matters about which it is expected would always be relevant to obtain evidence when testing management's process e.g. the appropriateness of changes from the prior year. This is only explicitly addressed under the "judgement" factor. While this factor would normally be applicable in a majority of cases, there is a risk of unintended consequences of matters that might always be expected not being addressed if a factor is not deemed to be the reason for the assessed risk. Similarly, the relevance and reliability of data only appears under "complexity". There may be significant data that is not necessarily complex.

4.6 We believe it is important to maintain a strong link with the requirements of ISA 315 and ISA 330. There is a risk that the multitude of concepts being incorporated into proposed Revised ISA 540, including the risk factors and "matters" about which the auditor needs to obtain evidence, risks confusion as to what the auditor is responding to.

4.7 We recommend that the understandability and practical application of the ISA can be enhanced by:

4.7. i Positioning the proposed risk factors of complexity, the need for the use of judgement and estimation uncertainty as useful considerations when thinking about the susceptibility of the estimate to error or fraud, or "where things can go wrong". They can help inform the auditor's identification and assessment of the risks of material misstatement at the assertion level, but should not be the basis for that assessment and response. This is consistent with how risk factors are used in ISA 240 and also how they have been incorporated into the proposed PCAOB standard.

4.7.ii Adopting a more intuitive structure for the response to assessed risks that better reflects the way in which audits of accounting estimates are actually approached. The three approaches available to the auditor, regardless of the level of assessed risk, are those set out in paragraph 15(a). We believe an overarching requirement, similar in nature to that proposed by the PCAOB, is appropriate that directs the auditor to determine an appropriate approach to respond to the assessed risks.

4.7. iii Incorporating requirements that provide further direction for each of the 3 approaches.

4.7. iv With respect to testing events subsequent to the balance sheet date, giving this greater prominence. If this approach is capable of providing sufficient appropriate audit evidence then this would, in most cases, be the most sensible approach. A requirement to directly address obtaining evidence from this approach, that precedes requirements under other approaches, appears warranted and would also, in our view, promote an element of scalability.

4.7. v Reorienting paragraphs 17 and 18 to individually address the method, data and assumptions. Both the proposed paragraphs largely focus on these "elements" of accounting estimates but, as noted, contain significant overlap. Restructuring would, in our view, eliminate this overlap, avoid any commonly expected procedures being overlooked by a subjective judgement as to applicable factor, and represent a more intuitive approach to thinking about how to respond to risks arising from the key elements of accounting estimates.

4.7. vi Creating a more explicit requirement that addresses expectations of the auditor when developing their own point estimate or range. While application material discusses broadly how an auditor might go about developing their own estimate or range we think it is more helpful to indicate the expected work effort if, for example, the auditor uses management's method or model, data or assumptions. Similarly, setting a clear benchmark in the requirements that, if the auditor uses their own method, model, data or assumptions, they need to have a reasonable basis for those selections would also be appropriate. Note, some further restructuring of the ordering of paragraphs 19 (estimation uncertainty), 20 (auditor ranges) and our suggested requirement is considered necessary.

5. **Does the requirement in paragraph 20 (and related application material in paragraphs A128–A134) appropriately establish how the auditor's range should be developed? Will this approach be more effective than the approach of "narrowing the range", as in extant ISA 540, in evaluating whether management's point estimate is reasonable or misstated?**

5.1 We support the intent of paragraph 20 and the revised language in part (b). The concept of "narrowing the range" in the extant ISA was felt as being disingenuous. With respect to part (a), questions arose as to the specific intent of the phrase "are supported by the audit evidence". There was uncertainty as to whether the reasonableness of the range was to be assessed based on audit evidence obtained from the procedures performed in, for example, testing management's assumptions, data etc., or if this requirement was implying that there was a need to obtain some further additional level of evidence. We believe the intent was the former and that this could be clarified simply in the application material. This would also hold true for when the auditor used their own assumptions or data, and a link back to both our proposed amended requirements (see question 4) in that regard would be useful

5.2 While we find the application material to be useful reminders, in particular the focus on management bias and the reasonableness of the disclosures, we do not anticipate any real change in practice in respect of the boundaries of the ranges that are developed. Assuming an appropriate work effort has been performed on the relevant inputs/elements of an accounting estimate (method, data, assumptions), the inherent estimation uncertainty associated with certain accounting estimates is such that the range of reasonably possible outcomes is very broad. The auditor cannot "audit away" inherent estimation uncertainty. We therefore support paragraph A134 and the importance of transparent disclosures about estimation uncertainty in the financial statements.

6. Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor's range to evaluate management's point estimate?

6.1 We strongly support the application material in paragraphs A142-A146, in particular paragraph A145. When the auditor develops a range that includes reasonably possible outcomes supported by the audit evidence and management's point estimate falls outside of that range, the misstatement cannot be anything other than the difference between management's point estimate and the nearest point on the auditor's range. Any suggestion that the misstatement is to a particular point in the auditor's range implies the auditor is capable of developing a point estimate, which in many cases is not possible and the reason why a range was developed.

6.2 Similarly, when management's point estimate does fall within the auditor's range then we agree that there is no misstatement. It is important that the auditor understands how management selected their point estimate and, taking into consideration the audit evidence obtained, whether such selection is consistent with the audit evidence. Any obvious indicator of management bias or selection of an amount within a range that is inconsistent with audit evidence obtained or decisions taken with respect to other accounting estimates should be challenged. We therefore support the related application material (A147-A152) addressing potential bias.

6.3 With respect to paragraph 23, it is unclear whether the requirement sets an expectation of determining that each accounting estimate is reasonable or misstated, as opposed to "the accounting estimates and related disclosures" collectively. The language used is leading to confusion as is the positioning of the requirement relative to paragraph 22, which clearly and explicitly states applies to "each" accounting estimate (that is subject to paragraphs 17-19).

6.4 In our view this evaluation has to be for each accounting estimate. Each estimate is being subject to procedures to enable the auditor to reach that conclusion. The "collective" assessment of reasonableness, including consideration of management bias, can only take place when considering the financial statements as a whole, and that is, correctly, best addressed in ISA 700.

6.5 We suggest that more application guidance including practical examples be given to bring out the requirements of paragraph 22 & 23 more clearly.

7. With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?

7.1 It is entirely appropriate that information used as audit evidence be assessed as to its relevance and reliability. In practice, given the broad range of external information sources that exist, further guidance may be needed on the nature and extent of the auditor's work effort in satisfying this requirement, particularly in situations where the availability of evidence may be limited given the source of the information. We believe there could be a stronger and more explicit link in ISA 540, specifically the response to risks, to the proposed new content in ISA 500. While paragraphs A82 and A83 highlight the potential risks relating to external information sources (and could also reference ISA 500), there is no equivalent material in the risk response section. A short application paragraph to accompany each of the requirements addressing assumptions and data, drawing this important link, seems appropriate.

7.2 There are also likely to be challenges in making the determination/distinction between an external information source and a management's expert depending on the nature of the information being provided to the entity. Therefore, we welcome the examples provided in application material.

7.3 With respect to the definition of external information source, we caution that the reference to "publicly available" is at risk of being misunderstood, notwithstanding application paragraph A1, and runs the risk of inadvertently narrowing the intended scope of the definition. We suggest deleting the words "publicly available" from the definition and using the application material to explain that the information is available to a "broad range of users upon request".

8. In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

a) Translations—Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-540.

8.1 No comments.

b) Effective Date—Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

8.2 We support an effective date of periods ending on or after 15 December 2019, on the assumption that the Board approves the revised ISA in March 2018 and that the usual ability to early adopt is maintained.

9. Other Comments

9.1 Terminology

9.1. i It is important that, to avoid unintended confusion, terminology be applied consistently throughout the ISA. For example, paragraph 3(c)(ii) continues to use the term "appropriate" in relation to management's selection of a point estimate and disclosures. This is unhelpful given that the term "reasonable" is used in the context of the same matters in the "Objective" of the ISA.

9.1.ii We note the explanation in the explanatory memorandum that there is inconsistency in terminology between proposed ISA 540 and ISA 700 (Revised) with respect to the use of the term "reasonable" or "adequate" as related to disclosures. ISA 700 (Revised) is, itself, internally inconsistent, using "reasonable" in describing the auditor's responsibilities. We support aligning ISA 700 (Revised) paragraph 13 with the objective of ISA 540 and with paragraph 39 of ISA 700 (Revised) and that this be addressed through the auditor reporting implementation review.

9.2 Understanding the Entity and Internal control

9.2. i There is some lack of clarity about what is expected by the new requirement in paragraph 10(c). It is also not clear as to how this differs from the requirements of paragraph 10(a). The distinction between this and understanding what has been included and how management made those estimates is too subtle and it is not clear as to what documentation would be required to satisfy this requirement.

9.2. ii The language used in paragraph 10(f) seems to imply that there is some separate consideration of internal control specific to accounting estimates, beyond what is required in ISA 315. We suggest that, with the concurrent revision of ISA 315, it may be appropriate for additional guidance to be added to that Standard to better explain key considerations relating to accounting estimates. However, we are not proposing a wholesale relocation of paragraph 10 to ISA 315, as we acknowledge the established structure adopted in developing these "subject-matter" specific ISAs is to address the end-to-end audit process.

9.3 Specialised skills

9.3.i We are not convinced of the necessity of the need for a separate requirement to determine whether specialized skills or knowledge are required in order to perform the risk assessment procedures or to identify and assess the risks of material misstatement. In using the work of a specialist in the audit, the auditor needs to have a sufficient understanding to be able to evaluate their work. While the auditor may wish to involve specialists in planning the audit, they can and should be in a position to evaluate risks of material misstatement. This is likely to result in boilerplate documentation. At a minimum, we recommend consolidating the two requirements addressing the potential use of specialists (paragraphs 12 and 14) such that identification and response to risks are addressed in one holistic requirement.

9.4 Significant risks

9.4.i We concur with the decision not to include any specific additional requirements unique to responding to risks related to accounting estimates. The Group did not identify any specific responses where they would expect to perform additional or different procedures to those required by the ED if the risk had been identified as significant.

9.5 Bias

9.5.i We agree that paragraph 24 needs to be assessed at the collective "estimates" level to be able to judge bias across the entire population of estimates, as some bias may only emerge at that level. This requirement does overlap considerably with the equivalent requirement in ISA 700 (Revised) and therefore recommend making this link more explicit.

9.6 Documentation

9.6. i We have concerns over what is expected in respect of documentation of:

- *a)* Paragraph 10(c) - The auditor's independent expectation of the nature of the accounting estimates the auditor expects to be included in the financial statements;
- *b)* Paragraph 10(f) – internal control;
- *c)* Paragraph 13 - Risk assessment;
- *d)* Paragraph 15 – Judgement on "low/not low" inherent risk;
- *e)* Paragraphs 17-19 – How procedures performed address these requirements given their inherent inter-relationship;
- *f)* Paragraph 23 – Level at which the evaluation is performed.

9.7 Other

9.7. i Paragraph A95 includes a statement that the ISA does not imply or require a separate assessment of inherent risk. In light of the paragraph 15(a) requirement this statement is factually incorrect.

9.7.ii While we appreciate that there is a dire need to enhance the audit quality bar, particularly in view of Public Interest involved in audit and also because of the growing expectation gap, it is felt that the draft ISA 540 is tending to be quite rule based. It needs to be more flexible in its requirements.