

August 7, 2017

IFAC Small and Medium Practices Committee Response to the IAASB's Exposure Draft, *Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures*

INTRODUCTION

The SMP Committee (SMPC) is pleased to respond to the IAASB (the Board) Exposure Draft (the ED), *Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures*. The SMPC is charged with identifying and representing the needs of its constituents and, where applicable, to give consideration to relevant issues pertaining to small- and medium-sized entities (SMEs). The constituents of the SMPC are small- and medium-sized practices (SMPs) who provide accounting, assurance and business advisory services principally, but not exclusively, to clients who are SMEs. Members and Technical Advisers serving the SMPC are drawn from IFAC member bodies representing 22 countries from all regions of the world.

GENERAL COMMENTS

The SMPC has closely followed the development of the ED and submitted comment letters in advance of a number of the IAASB quarterly Board meetings. We support the IAASB revising ISA 540¹ and commend the Board on the considerable amount of work that has been undertaken in developing the proposals. Accounting estimates can be very complex and both today, and in the future, will continue to be an important element of financial statements, so the ED represents significant progress.

Overall, we appreciate the relative conciseness of the requirements' section and welcome the IAASB's attempts to make ISA 540 (Revised) scalable and the proposed approach in as far as it would ensure accounting estimates assessed as low inherent risk are not subject to inappropriate audit procedures. We broadly support the notion of low inherent risk as a threshold, but strongly believe that to foster consistent treatment of accounting estimates it will need to be explained more thoroughly, and its relationship to the risk of material misstatement further explored. In addition, not all SMEs accounting estimates will be assessed as low inherent risk. It is therefore critical that the IAASB examines how there could be further scalability in the approach, as these issues are not sufficiently addressed with just the introduction of the threshold.

We are concerned that ED-540 is over-engineered in some respects, in particular for SMPs. IAASB implies, but does not state, that the intention is not to make extensive changes in the audit of accounting estimates when inherent risk is low and that this is how the ISA achieves scalability. However, it is clear from the requirements that despite the structural similarity between the extant standard and the proposals with regard to low inherent risk estimates, considerably more is in fact required, even for low inherent risk estimates. We do not believe that IAASB is in a position to unwind the potentially disproportionate

¹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*



complexity for some SME audits and we therefore strongly recommend that further SME examples should be included in a separate staff publication. The publication should also cover (a) the link between inherent risk and risk of material misstatement, (b) how the standard can be applied efficiently specifically to smaller audits, such as highlighting the additional work now required for low risk estimates, as well as giving examples how the new requirements for other estimates can be applied efficiently, and (c) examples of the types of documentation that might be appropriate in SME audits. Guidance on the demonstration of professional skepticism when auditing accounting estimates would be particularly helpful for SME auditors where the estimate is complex and management has used data and assumptions in a model. This is an emerging area for many SMEs and their auditors.

We support the additional clarity that has been provided in the standard, including understanding the inter-relationship between judgment, complexity and estimation uncertainty. However, these three factors are very closely interrelated and we believe that the IAASB needs to give this further consideration prior to finalization.

In our view, the IAASB should be sensitive to the risk of increasing public expectations of an audit where an accounting estimate is subject to a significant degree of estimation uncertainty. For instance, increasing the level of prescription in particular areas of ISA 540 (Revised) may inadvertently increase public perception that provided the entity applies the “right” process or model, an acceptably reliable estimate can “more or less always” be included in the financial statements. In reality, the desired degree of exactitude may inevitably remain unattainable in respect of certain accounting estimates. Although the introduction explains that accounting estimates are subject to inherent limitations, this material could be more explicit as to the equivalence of the limitations this places on the preparer’s and auditor’s ability in the context of measurement uncertainty. Otherwise there may be unrealistic expectations that the auditor can “enhance” the actual degree of reliability of an accounting estimate - an audit cannot make inherently uncertain measurements more precise than they are.

We therefore believe that the IAASB has an educational role in explaining the responsibilities of other stakeholders in the financial reporting supply chain for accounting estimates. For example, highlighting the responsibility of management to provide auditors with adequate information on a timely basis for their accounting estimates when preparing financial statements. The information required from management with the new standard may require more detail on the inputs, ranges etc., but in general this is not considered negative, as it should lead to enhanced evidence and documentation on audit files.

DETAILED COMMENTS

We have outlined our responses to the questions (in italics) in the ED below.

Overall Questions

Q1. Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?



One of the driving factors of the project to revise ISA 540 is the impending adoption of IFRS 9², which has been considered in the proposals. However, it is less clear about other new international reporting standards, including leases (IFRS 16³), revenue recognition (IFRS 15⁴) and insurance contracts (IFRS 17⁵) as so much of the guidance is for financial instruments, as well as being more relevant for high inherent risk accounting estimates.

Furthermore, there are many financial reporting frameworks, particularly those based on IFRS, which increasingly require the use of fair values in SME financial statements. This reinforces the need for better quality guidance on how the extensive and complex requirements relating to non-low inherent risk (IR) estimates apply to the audit of SMEs.

We broadly support the IAASB's proposal to make significant revisions to the definition of the term "accounting estimate" in paragraph 9(a). The wording may need to be revised slightly in order to be clear that the uncertainty relates to the assumptions applied in measuring the subject matter.

Q2. Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?

In general, the requirements and application material appropriately reinforce the application of professional skepticism when auditing accounting estimates. A key factor will continue to be how much evidence and documentation is needed for auditors to support that they have challenged management effectively and the degree of skepticism that was exercised on the audit i.e. what will be considered 'enough' by regulators. There is a risk that an expectations gap would be increased with additional recognition of professional skepticism.

Focus on Risk Assessment and Responses

Q3. Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?

SME financial statements include non-low IR estimates

The SMPC fully appreciates the IAASB's recognition of the need to consider scalability as many audits performed world-wide concern smaller and less complex entities. While many accounting estimates in SME financial statements will be assessed as low inherent risk, this will not be the case with all of them. We note above the need for better quality guidance on how the extensive and complex requirements relating to non-low IR estimates apply to the audit of SMEs. We broadly support the notion of low inherent risk as a

² International Financial Reporting Standard (IFRS 9), *Financial Instruments*

³ International Financial Reporting Standard (IFRS 16), *Leases*

⁴ International Financial Reporting Standard (IFRS 15), *Revenue from Contracts with Customers*

⁵ International Financial Reporting Standard (IFRS 17), *Insurance Contracts*



threshold, but also strongly believe that there could be further scalability in the approach when the inherent risk is not low. For example, it should be made clear that the three procedures listed for low inherent risk estimates (paragraph 15 (a)) may also be appropriate to other estimates - what is important is that the procedures designed and performed are an appropriate response to the specific risks.

Overall, we are concerned that ED-540 is over-engineered in some respects, in particular for SMPs, if the intention is not to make extensive changes in the audit of accounting estimates when inherent risk is low. For example, whilst it may not appear that the required response to low inherent risk accounting estimates is a significant change from the extant ISA 540, the proposals give the impression that a substantial increase in work is required to assess the risk associated with many estimates (especially the requirements in paragraph 10), only in many cases to arrive at the same place as before. For instance, for a small business, an auditor may simply conduct their own point estimate and compare it to the result provided by management, without needing to necessarily understand all of the intricacies the latter have used to come up with their own estimate. The proposed standard now requires an understanding of what management did, which may not contribute to any additional (or more persuasive) evidence to the audit and just represents additional work effort.

We are also concerned about the additional documentation that will be needed for practitioners to demonstrate how they meet all the requirements, especially as this could be easy to criticize under a regulatory inspection environment. As a result, the cost/ benefit of the changes are likely to be disproportionate for many SMPs and may not enhance audit quality i.e. there needs to be an appropriate balance between the time spent undertaking audit procedures and level of documentation.

The low IR threshold

Some SMPs methodologies may have moved in accordance with the ISAs to focus on significant risks, but some firms still use low, medium and high inherent risk. If firms use the words “low”, “moderate”, and “high” for the assessment of inherent risk, “not low” could be seen as very wide including both moderate and high. The scope of “low” and “not low” is unclear from the proposals and more is needed on what is involved in a low IR assessment.

It is essential for the Board to include greater clarification on what is meant by low inherent risk and the link between inherent risk and risk of material misstatement. There is a concern about which types of estimate fit in which ‘bucket’ and the size of these relative to each other. In particular, practitioners may waste time and effort trying to either fit, or not fit, an accounting estimate in one ‘bucket’. It would be useful if the application material acknowledges that there is considerable crossover between when inherent risk is low and ‘simple’ or ‘non-complex’ estimates. Consideration could also be given to whether there is a way of indicating in the application material that the trigger should be at the higher end of complexity, judgment and certainly estimation uncertainty.

In our view, it would be helpful if the IAASB could provide more detail on the examples of estimates that might be considered low inherent risk (A72), and others which are not (A73), and how they might be dealt



with under various scenarios. We recommend that further SME examples could be included in a separate staff publication, but additional lists in the standard may not be helpful given the potential for misuse by practitioners and regulators and the length of the proposed standard. The staff publication could also cover the link between inherent risk and significant risk of material misstatement, how the standard can be applied efficiently to smaller audits and the expected level of documentation, so it is clear for both practitioners and regulators.

There can be circumstances where auditors may be in a position to identify accounting estimates as being of low inherent risk without having first performed all the work steps required under proposed paragraph 10 of the ED, which are excessive. In particular, the requirements to understand each of the components of internal control as they relate to making accounting estimates (paragraph 10(f)), is not clear about the fact that controls auditors are required to understand are only those *relevant to the audit*. We therefore suggest this aspect be revisited to establish whether scalability in the required risk assessment procedures could be improved. We acknowledge and welcome the material in A10, A23 and A60 in relation to smaller entities, which are generally considered helpful, although may still need some refinement. For example, the first sentence of A23 makes two references to “less complex”.

Q4. *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 estimate 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?*

While the three factor approach makes sense, complexity, judgment and estimation uncertainty are all closely interrelated and the distinction to a certain extent seems artificial. There is a concern that the requirement to focus the audit approach depending on which of these are the main ‘driver’ may result in two of the three factors being adopted in virtually all cases, and all three in many, just to avoid regulatory challenge. The IAASB could give more consideration to whether there are discrete examples in which only one factor is relevant. For example, if complexity alone is the reason behind a not low assessment of inherent risk, the auditor can successfully address this factor with the “right” audit procedures.

In our opinion, the IAASB should consider addressing the non-accounting estimate specific issues of complexity and use of management judgement in the current project to update ISA 315 (Revised)⁶. It is extremely important that the approach in both projects is coordinated.

⁶ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*



We believe that a greater emphasis on 'judgment' and an explicit linking between judgment and management bias could be included. The auditors greatest 'weapon' in auditing estimates lies in understanding management's motivations, incentives and biases in preparing estimates and this could be brought out more in paragraph 18 or the overall evaluation based on the audit procedures performed in paragraphs 22 and 23.

While in paragraph 13, the standard makes clear that complexity, judgment and estimation uncertainty are not the only relevant factors the auditor shall take into account the extent to which the accounting estimate is subject to, there is a concern that additional factors or alternatives will not be taken into account in practice. Furthermore, while paragraph A78 includes other relevant factors, we believe that the reference to "the regulatory environment" could be expanded. For example, considering the impact of other factors, such as the geopolitical environment, technological developments or other disruptive factors when evaluating whether the estimates prepared by management are reasonable.

We note that the paragraph 28 of the Explanatory Memorandum states that *"the requirements in paragraphs 17-19 are not drafted in the form of procedures that shall all be performed, or a list of possible procedures from which the auditor shall choose. Instead, these paragraphs contain requirements that are focused on objectives that the procedures selected by the auditor need to accomplish"*. Despite IAASB's best intentions, there is a feeling of an overly prescriptive work effort in each of the three areas. The IAASB will need to work hard to change existing mind-sets which are not accustomed to objectives-based requirements. Significant effort will be necessary to explain to practitioners (in firms of all sizes) and regulators that the requirements in paragraphs 17 to 19 are not all procedures, and are intended to be objectives based requirements.

We agree that analysis of the three factors is useful in identifying and assessing the risk, but it could be less useful in determining the appropriate response. We are concerned that the requirements have been worded to seem as though practitioners would need to address all the matters/ procedures, which could drive a compliance mind-set as regulators will interpret these as a must. The documentation of the sub-components might present practitioners with a challenge because the differences between estimation uncertainty, complexity and judgment are extremely nuanced. The IAASB should consider whether some of the material is more appropriate for application guidance rather than in the requirements.

The use of the term "significant data" in requirement 17 (a) would benefit from clarification or perhaps a link to other relevant application material (e.g. A35, A39 – A42). The Board could consider whether it should refer to whether management has also considered different scenarios that may occur, the impact on the significant data and therefore on the final accounting estimate. The IAASB should also consider whether it intends that there is a difference between the requirement to consider if significant data is reliable (para. 17 (a)) and its integrity (para. 17 (d)). Practitioners may have difficulty distinguishing between the two.

Paragraphs 18 and A111 use the words "intent" and "ability", but it is not easy to understand what these mean. We encourage the Board to consider adding additional explanation of these terms.



Q5. *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?*

We agree with the IAASB that the proposed approach is more appropriate than that of "narrowing the range" in extant ISA 540. However, more information and guidance is necessary in regards to the relation between materiality and how the auditors range should be developed. This would be particularly important for practitioners that do not have extensive practical experience.

It could be made clearer that an accounting estimate is reasonable and not misstated if it is disclosed properly using a representative point estimate that the framework requires. In addition, paragraph 20 (a) states "*are supported by the audit evidence*", which may cause some confusion as accounting estimates are based on future events, most of which are not supported by currently available evidence. Additional application guidance may be needed to make this clear.

Q6. *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?*

We note that the only other ISA that deals specifically with a line item in the financial statements is ISA 501⁷. However, ISA 501 stops short at requiring the auditor to obtain sufficient appropriate audit evidence on, or evaluating reasonableness of, the single line item. Pursuant to ISA 200⁸, the auditor is required to obtain sufficient appropriate audit evidence to reduce the audit risk to an acceptably low level. ISA 200.17 establishes this as a prerequisite to obtaining reasonable assurance and to enable the auditor to draw reasonable conclusions on which to base the auditor's opinion. The proposed wording in para. 23 requires the auditor "*... based on the audit evidence obtained*" to evaluate "*whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated*". Explanation of the relationship between the two standards and the auditor's opinion on the financial statements as a whole would be helpful, as it may be unclear as to whether such "reasonableness evaluation" could constitute some form of piecemeal opinion.

In addition, there is a lack of reference to the concept of materiality in the ED which directly impacts all of the requirements mentioned in paragraph 23 and its related application material A2-A3 and A142-A146.

We believe that the proposed paragraphs 22 and 23 should make clear whether they relate to individual estimates or estimates collectively. Logically paragraph 23 of the ED should follow the auditor's step back

⁷ ISA 501, *Audit Evidence – Specific Considerations for Selected Items*

⁸ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*



evaluation as to whether there are indications of possible management bias, and so might be more appropriately located subsequent to paragraph 24.

It could also be questioned, that if it makes sense to expressly have a stand-back provision why this is not a requirement in other ISAs. In our opinion, an overall emphasis would be more appropriate in ISA 700⁹ to stand back on the financial statements as a whole, rather than at a collective estimates level.

Conforming and Consequential Amendments

Q7. 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?

In general we are concerned that the combined impression portrayed by the volume and “granularity” of material the IAASB is proposing to add as conforming amendments could lead to an expectation that in practice may not be realistic.

The IAASB should consider situations where an auditor may be faced with an audit client’s use of a valuation service where information is not publicly available and the service provider is not willing to divulge algorithms etc. to allow the auditor to test their suitability etc. The auditor could be confronted with what is essentially a “black-box”, but as the service is not specific to the entity it does not constitute the use of a management expert. Therefore, including the words “publicly available” in the definition proposed in ISA 500 (cA) and referring to this in A1A and A1C means that this type of circumstance is not covered.

Request for General Comments

Q8. 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.

The main issue (as with all translations of technical material) is the risk of losing actual meaning of the material upon translation. Use of plain English will assist with minimizing this risk.

(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

⁹ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*



permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

We appreciate the fact that regulators in particular are calling for the IAASB to deliver a revised ISA 540 as soon as possible. As the Board is aware, it is vitally important that the ISA 540 Task Force and ISA 315 (Revised) Task Force are as coordinated as much as possible in their approaches, to avoid a situation where the IAASB might need to revise ISA 540 within a relatively short period after its publication.

An 18 month period would be a minimum from our point of view. We recommend a 24 month period after approval of the final ISA as it will take significant time for professional accountants, translators and industry to prepare for the changes.

It would be helpful if the effective date is made for a common financial reporting date (e.g. effective for audits of financial statements for periods ending on or after December 15 [or June 15], 20XX). This would assist implementation for firm's methodologies, training manuals etc.

More detailed drafting comments

In general, the new appendices were considered helpful with the information better placed there than in application material. However, the status must be very clear and be referred to in the introduction. The IAASB could consider publishing this separately from the standard, especially given the overall length.

The application material is lengthy and reads more like a textbook than implementation guidance. Such material is valuable, but IAASB must consider going forward whether this type of material should be supplied in another form to those auditors who wish to have a comprehensive reference. We do not comment on the entire application material, but point to selected instances where we believe the IAASB could make further changes:

- Some material could arguably be more appropriately placed in the introduction. For example, part of paragraph A7 is relevant to the paragraph 5.
- We also note instances of departure from the IAASB's stated drafting conventions. For example paragraph A9 reads as though it is a part of the requirement of paragraph 10.
- Some material in the ED appears to be nonessential or superfluous. For example, paragraph A13 does not add value to the Standard.
- Inconsistency between regulatory requirements and the requirements of the applicable financial reporting framework may not indicate risks of material misstatements as they may not be comparable. Further explanation could be needed in A15.
- The inclusion of A44 and considerations specific to smaller entities should be earlier in the standard. We suggest in the preamble prior to paragraph 10, rather than 10 (e) (iv).
- The guidance in A43 could provide instances when management does not have an expert – it should not only apply to anything that requires an expert. In addition, the use of an expert in a valuation should not in itself necessarily result in the assessment of inherent risk other than low.



- The guidance in A75 could be particularly helpful for SMPs who may well be conducting audits at a point in time when information is known, but it is currently difficult to understand. It could be made much clearer that it is intended to assist when the outcome of an accounting estimate became known during the audit and the inherent risk was assessed as not low during the planning stage. Furthermore, the use of “when relevant” could be seen as superfluous.

CONCLUDING COMMENTS

We hope that the IAASB finds this letter useful. We are committed to helping the Board in whatever way we can to build upon the results of the Exposure Draft.

Please do not hesitate to contact me should you wish to discuss matters raised in this submission.

Sincerely,

Monica Foerster

Monica Foerster
Chair, SMP Committee