

## Analysis of Responses to Question 1 of the Exposure Draft

### Section I: Question included in Exposure Draft

1. The following question was asked in the Exposure Draft:
  1. *Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?*

### Section II: Staff Analysis of Respondents' Views<sup>1</sup>

#### General Observations

2. Many respondents, including one Monitoring Group member,<sup>2</sup> indicated generally that the Exposure Draft of Proposed ISA 540 (ED-540)<sup>3</sup> has been appropriately updated to deal with evolving financial reporting frameworks and their effect on the auditing of accounting estimates, particularly complex estimates. Respondents commented positively in varying degrees on the focus in ED-540 on the use of complex models, forward-looking information, testing of internal controls, and the importance of disclosures, while also noting that additional requirements or guidance in these areas may be helpful.
3. However, various levels of concern were expressed about whether ED-540 sufficiently addressed the unique issues presented by the introduction of the expected credit loss (ECL) model or issues in the audits of entities in the insurance industry. This is discussed further in the "Monitoring Group Responses" and "Comments on Sector-Specific Guidance" sections below.
4. Some respondents<sup>4</sup> commented in various ways about the framework-neutral position of the ISAs, either noting the challenges in including requirements linked to a specific framework, or indicating that the expanded requirements and application material in ED-540 allow the standard to remain principles-based in dealing with evolving financial reporting frameworks.
5. One respondent<sup>5</sup> noted that the principles-based nature of the ISAs means that ISA 540 (Revised) cannot, nor should it attempt to, address in detail all the various emerging accounting requirements, including those relating to specific industries. However, this respondent believed that there is a need for separate guidance to help apply the standard to different types of complex estimates, and expressed support for the IAASB to develop International Auditing Practice Notes

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<sup>1</sup> In this paper the following terms have been used:

- "A respondent" = 1;
- "A few" = 2–3;
- "Some" = 4–6;
- "Several" = 7–11;
- "Many" = 12–34;
- "Majority" = more than 50%; and
- "Significant majority" = greater than ~80%.

<sup>2</sup> *Regulators: IAIS, IRBA, NSSs: HKICPA, IDW, NBA, Firms: BDO, DTT, EYG, PKF, RSM, Public Sector: ACAG, AGC, CIPFA, GAO, PAS, Member Bodies: AE, ANAN, FACPCE, IAA, IBR-IRE, ICAG, ICAP, ICAZ, ICPAK, KICPA, SAICA*

<sup>3</sup> Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>4</sup> *Member Bodies: CAI, SAICA, Firms: GTI, PWC, Individuals & Others: NDEG*

<sup>5</sup> *Regulators: UKFRC*

(IAPN) or other publications as appropriate. Some respondents had similar views,<sup>6</sup> with varying suggestions as to the form and content of such guidance.

6. One respondent<sup>7</sup> indicated that, although ED-540 has been appropriately updated to deal with the evolving nature of the International Financial Reporting Standard (IFRS), the IAASB needs to ensure that the scope of the revised standard remains appropriate in view of the fact that other financial reporting frameworks may not have changed significantly.
7. One respondent<sup>8</sup> supported targeted amendments to extant ISA 540,<sup>9</sup> with explicit links to ISA 315 (Revised)<sup>10</sup> and ISA 330<sup>11</sup> that would address recent inspection findings and relevant changes to financial reporting frameworks rather than overhauling the entire standard.
8. Some respondents believed that ED-540 was overly focused on auditing complex accounting estimates (e.g., ECL and other estimates in the financial sector). Of the respondents expressing this view, a few noted that ISA 540 (Revised) also needs to focus on considerations relevant to accounting estimates in the non-financial sector,<sup>12</sup> or believed that the standard needs to be more balanced to make it more scalable and relevant to entities in different industries and of varying sizes.<sup>13</sup>
9. Some respondents<sup>14</sup> noted that additional examples or guidance could be provided related to areas that were the subject of other recently accounting pronouncements issued, such as revenue recognition (IFRS 15), leases (IFRS 16) and insurance contracts (IFRS 17 – see “Comments on Sector-Specific Guidance” below).
10. A few respondents<sup>15</sup> observed that accounting estimates in the public sector are becoming increasingly complex, and recommended that additional examples or guidance be provided to adequately address auditing issues relating to estimates for public sector organizations.
11. A few respondents<sup>16</sup> noted that the increasingly complex financial reporting regime is relevant not only to auditors but to preparers, and had various suggestions in this regard.

### Monitoring Group Responses

12. Two members of the Monitoring Group<sup>17</sup> noted their preference for a focus on issues for audits of financial institutions or entities in the insurance industry.
13. In this respect, one member of the Monitoring Group<sup>18</sup> noted that they would have preferred that the IAASB focus on issues for audits of financial institutions arising from the adoption of ECL

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<sup>6</sup> *Regulators: IRBA, Member Bodies: AICPA, CAI, ICAEW, NSSs: AUASB*

<sup>7</sup> *NSSs: IDW*

<sup>8</sup> *Member Bodies: AICPA*

<sup>9</sup> *ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>10</sup> *ISA 315 (Revised), Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

<sup>11</sup> *ISA 330, The Auditor's Responses to Assessed Risks*

<sup>12</sup> *NSSs: AUASB, CAASB, NZAUASB, Member Bodies: ACCA-CAANZ Public Sector: ACAG*

<sup>13</sup> *NSSs: AUASB, CAASB, NZAUASB, Member Bodies: CPAA, EFSA, SMPC*

<sup>14</sup> *Regulators: ESMA, Firms: BDO, Member Bodies: AE, CAI, IBR-IRE, ICAS, SMPC*

<sup>15</sup> *NSSs: NZAuASB, Public Sector: AGA, INTOSAI*

<sup>16</sup> *Member Bodies: ICAEW, ICAS*

<sup>17</sup> *Regulators: BCBS, IAIS*

<sup>18</sup> *Regulators: BCBS*

frameworks, but agreed that ED-540 will improve the requirements and guidance for the audit of complex accounting estimates (in general) for all types and sizes of entities. Another Monitoring Group member<sup>19</sup> indicated generally that ED-540 has been appropriately updated to cover key matters in the development of accounting estimates, but strongly encouraged the IAASB to consider on a priority basis the further development of application or guidance material, such as an IAPN, to better address the specific considerations around auditing insurance contract liabilities.

14. A Monitoring Group member<sup>20</sup> believes that the IAASB should give priority to a further project to develop additional guidance relating to testing the valuation of financial instruments. This respondent also believes it is important to provide specific guidance on the audit of accounting estimates in areas such as loan loss provisioning under an expected loss model, impairment of non-financial assets, tax balances, and valuation of insurance policy liabilities.

### Other Comments on Sector-Specific Guidance

15. A respondent<sup>21</sup> expressed serious concerns about whether the proposed requirements in ED-540 are sufficiently specific to ensure the effective audit of complex models led by the introduction of ECL models for impairment of financial assets under IFRS 9 or valuation of insurance liabilities at their fulfillment value under IFRS 17. Accordingly, in the view of this respondent, the audit of the application of the ECL model might require specific guidance, notably with respect to the testing of effectiveness of controls and to the governance over the modelling and validation processes.
16. A few respondents<sup>22</sup> noted that the IAASB had considered addressing specific issues relating to the audit of financial institutions in a separate International Auditing Practice Note, and strongly urged the IAASB to continue to pursue this guidance as a matter of priority or be prepared to provide such guidance as part of its implementation monitoring efforts.
17. Some respondents<sup>23</sup> also supported a need for, or consideration of, additional guidance for the auditing of ECL models under IFRS 9<sup>24</sup> or insurance contracts under IFRS 17, either in ISA 540 (Revised) or in a separate publication such as an IAPN.

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<sup>19</sup> *Regulators: IAIS*

<sup>20</sup> *Regulators: IOSCO*

<sup>21</sup> *Regulators: ESMA*

<sup>22</sup> *Regulators: ESMA, Member Bodies: AE, ICAEW*

<sup>23</sup> *Member Bodies: ICAEW, NASBA, NSSs: CNCC-CSOEC, MAASB, Firms: BDO, Public Sector: CIPFA,*

<sup>24</sup> *IFRS 9, Financial Instruments*