

## Agenda Item 2-F.2

### Analysis of Responses to Question 2 of the Exposure Draft

#### Section I: Question included in Exposure Draft

1. The following question was asked in the exposure draft:
  2. *Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?*

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

##### Monitoring Group Responses

2. A few monitoring group respondents generally believed that the approach taken in Exposure Draft of Proposed ISA 540 (ED-540)<sup>2</sup> appropriately reinforces the application of professional skepticism when auditing accounting estimates.<sup>3</sup>
3. One Monitoring Group member acknowledged the Professional Skepticism Working Group established by the IAASB, and urged the IAASB to continue the work of that group on a priority basis.<sup>4</sup>
4. Two Monitoring Group members<sup>5</sup> noted that the IAASB should continue to look for other ways to address professional skepticism in the revision of ISA 540,<sup>6</sup> such as with additional guidance or examples. A Monitoring Group member noted that more could be done outside of ISA 540 to reinforce professional skepticism.<sup>7</sup> Another Monitoring Group member noted that the material in paragraph A101 on alternative concepts, techniques, or factors could be relevant for factors other than complexity.<sup>8</sup>
5. Two members of the Monitoring Group<sup>9</sup> commented on the interrelationship of professional skepticism with management judgment. One<sup>10</sup> recommended that the IAASB includes examples of how auditors can demonstrate the application of professional skepticism for accounting estimates that are subject to a high degree of management judgment, and therefore may be more susceptible to the potential for management bias (paragraph A85). This respondent also

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

<sup>3</sup> *Regulators: BCBS, IAIS*

<sup>4</sup> *Regulators: BCBS*

<sup>5</sup> *Regulators: BCBS, IOSCO,*

<sup>6</sup> *ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>7</sup> *Regulators: IAIS*

<sup>8</sup> *Regulators: IFIAR*

<sup>9</sup> *Regulators: BCBS, IAIS*

<sup>10</sup> *Regulators: BCBS*

recommended that paragraph 5 be strengthened to note the importance of demonstrating professional skepticism throughout the audit.

6. In this regard, two monitoring group respondents<sup>11</sup> supported more emphasis around auditors challenging management's assumptions, particularly when the risks of material misstatement are not low due to the extent of judgment applied and when assessing management bias. One Monitoring Group member also supporting strengthening the focus on the consistency of management's assumptions within an entity and in comparison with objective information and market data.<sup>12</sup> Another Monitoring Group member also focused on the need for the auditor to question management's evidence on an ongoing basis during the normal course of the audit and should appropriately document this process in the auditor's work papers.<sup>13</sup>

### General Observations

7. A majority of respondents<sup>14</sup> generally believed that the approach taken in Exposure Draft of Proposed ISA 540 (ED-540)<sup>15</sup> appropriately reinforces the application of professional skepticism when auditing accounting estimates. In particular, respondents most noted the following key provisions of ED-540 as improvements:
- Emphasizing the importance of professional skepticism in the introduction (paragraph 5)
  - Enhanced risk assessment requirements (paragraph 10)
  - More granular, objectives-based work effort requirements to help auditors tailor the response to address the underlying drivers of the assessed risk of material misstatement (paragraphs 17-20)
  - The stand-back provision, including the consideration of all audit evidence obtained, whether corroborative or contradictory (paragraph 23)
  - Additional focus on the consideration of management bias (paragraph 24)
8. Notwithstanding the level of support for these provisions in ED-540, respondents also expressed certain concerns and offered additional suggestions for further strengthening the requirements and guidance regarding the application of professional skepticism. These are discussed further in the sections below.
9. Several respondents<sup>16</sup> expressed support for the IAASB's approach of reinforcing the application of professional skepticism through the nature of the requirements and related application material rather than including sprinkling statements or reminders about the concept throughout the standard. Others noted the importance of continuing to liaise with regulators on this topic.<sup>17</sup>

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<sup>11</sup> Regulators: **BCBS, IAIS**

<sup>12</sup> Regulators: **IAIS**

<sup>13</sup> Regulators: **BCBS**

<sup>14</sup> Regulator: **BCBS**, ESMA, **IAIS**, IRBA, UKFRC, *Investors & Analysts*: CFA, NSS; AUASB, CAASB, CNCC-CSOEC, HKICPA, IDW, MAASB, NZAuASB, *Accounting Firms*: BDO, DTT, EYG, GTI, KPMG, PKF, PWC, RSM, *Public Sector*: ACAG, AGA, AGC, AGNZ, CIPFA, GAO, INTOSAI, PAS, *Member Bodies*: ACCA-CAANZ, AE, AICPA, ANAN, CAI, CPAA, EFAA, FACPCE, IAA, IBRACON, ICAG, ICAP, ICAS, ICAZ, ICPAK, KICPA, NASBA, SAICA, SMPC, *Individuals & Others*: NDEG

<sup>15</sup> Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

<sup>16</sup> Regulators: UKFRC, *Firms*: DTT, PWC, *NSSs*: AUASB, *Member Bodies*: CPAA, ICAEW, ICAS, *Individuals & Others*: NDEG

<sup>17</sup> *Member Bodies*: AE, ICAEW, ICAS, SMPC

10. A number of respondents acknowledged the Professional Skepticism Working Group established by the IAASB, and urged the IAASB to continue the work of that group on a priority basis.<sup>18</sup> Other respondents<sup>19</sup> noted that the IAASB should continue to look for other ways to address professional skepticism in the revision of ISA 540,<sup>20</sup> such as with additional guidance or examples. Two respondents noted that more could be done outside of ISA 540 to reinforce professional skepticism.<sup>21</sup>
11. Two respondents<sup>22</sup> suggested that the final standard be clear that the auditor cannot reduce inherent estimation uncertainty by performing more audit procedures and applying professional skepticism.
12. A few respondents<sup>23</sup> noted that the prescriptiveness and rules-based nature of the standard, along with length of the application material, may result in a checklist mentality being applied, which may diminish the auditor's professional judgment and professional skepticism and lead to an unintended decline in audit quality.

### Links to Management Bias and Management Judgment

13. Respondents commented in various ways about the link between the application of professional skepticism and the consideration of possible management bias and the need for management judgment in making accounting estimates.
14. Several respondents noted that an important aspect of applying professional skepticism relates to evaluating management's judgments, including the selection of assumptions and methods. In this regard, one respondent<sup>24</sup> noted the absence of clear requirements for the auditor to challenge whether management's judgments were the most appropriate in the circumstances, and suggested there is room for use of words such as "question" and "challenge" in this context. Some other respondents agreed.<sup>25</sup>
15. Some respondents<sup>26</sup> indicated that the guidance relating to management bias could be clarified. Two respondents<sup>27</sup> suggested that the auditor's focus should be on identifying and assessing indicators of *inappropriate* management bias, i.e., bias which could result in material misstatement, noting that indicators of possible management bias themselves do not constitute misstatements for the purpose of drawing conclusions on the reasonableness of individual accounting estimates.

### Stand-Back Requirement

16. Respondents suggested various enhancements to, and the need for clarification of, the stand-back provision. These comments and suggestions include:

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<sup>18</sup> *Regulators: BCBS, ESMA, AE, Member Bodies: IBRACON, Investors & Analyst: CFA*

<sup>19</sup> *Regulators: BCBS, EBA, ESMA, IOSCO, IRBA, NSSs: NBA, Member Bodies: ICAP*

<sup>20</sup> *ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

<sup>21</sup> *Regulators: IAIS, Member Bodies: IBR-IRE*

<sup>22</sup> *NSSs: NBA, Regulator: AE*

<sup>23</sup> *Regulators: ESMA, NSSs: AUASB, NZAuASB, Public Sector: AGNZ*

<sup>24</sup> *Regulators: UKFRC*

<sup>25</sup> *Regulators: BCBS, EBA, IAIS NSSs: AUASB*

<sup>26</sup> *Firms: GTI, KPMG, Member Bodies: ACCA-CAANZ, Regulators: BCBS, Member Bodies: MAASB*

<sup>27</sup> *Firms: GTI, KPMG*

- The requirement needs to be more explicit in its wording and call out exactly what the intent of the requirement is.<sup>28</sup>
  - The stand-back evaluation should be amended to focus on whether the auditor has exercised a sufficient level of professional skepticism.<sup>29</sup>
  - It is not clear whether the stand-back provision applies when the auditor has assessed the inherent risk of the estimate as “low”, or only when the inherent risk is assessed as “not low”.<sup>30</sup>
  - Provide application guidance addressing examples or best practices in performing the stand-back review in order to demonstrate the application of professional skepticism.<sup>31</sup>
17. One respondent<sup>32</sup> questioned how the stand-back requirement is different from what is done currently on audits and therefore whether the addition of this requirement would be effective in driving the application of professional skepticism. This respondent also noted that subjectivity and bias are inherent features in some accounting estimates, for example, expected credit losses, and as such, there will be no practical way to reduce management bias in these estimates.

### Documentation

18. Several respondents, including one Monitoring Group member,<sup>33</sup> called for various enhancements to the documentation requirement and related application and other explanatory material to demonstrate the application of professional skepticism.

### Other Suggestions for Changes to Requirements or Application Material

19. Additional suggestions relating to various aspects of ED-540 were provided by respondents, often noting that guidance in these areas would contribute toward the goal of enhancing professional skepticism. These suggestions included the following:
- Clearer requirements and application guidance in the final standard that the requirement to produce evidence supporting the reasonableness of accounting estimates lies with the preparer, not the auditor.<sup>34</sup>
  - Require the auditor to consider whether management has used the *most* appropriate, rather than *an* appropriate, approach in making an accounting estimate in view of the circumstances.<sup>35</sup> This would support the auditor’s responsibilities to communicate with those charged with governance in accordance with ISA 260 (Revised).<sup>36</sup>
  - Additional guidance on the auditor’s evaluation of qualitative disclosures.<sup>37</sup>
  - Additional guidance on dealing with contradictory evidence. For example, considering revisions to the requirements before the stand-back to drive actions that are more likely to

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<sup>28</sup> NSSs: AUASB, Firms: BDO

<sup>29</sup> Regulators: BCBS, EBA, IOSCO

<sup>30</sup> Regulators: IRBA Firms: GTI, Member Bodies: NZAuASB

<sup>31</sup> Firms: BDO, Preparers of Financial Statements: ABA, Member Bodies: ICAEW

<sup>32</sup> Preparers of Financial Statements: ABA

<sup>33</sup> Regulators: BCBS, EBA, Firms: BDO, Member Bodies: ACCA-CAANZ, IBRACON, ISCA, SMPC, NSSs: AUASB

<sup>34</sup> NSSs: AUASB

<sup>35</sup> Regulators: UKFRC

<sup>36</sup> ISA 260 (Revised), *Communication with Those Charged with Governance*

<sup>37</sup> Firms: EYG, Member Bodies: ICAS, SAICA

ensure the auditor identifies potential alternative sources of evidence that may be contradictory,<sup>38</sup> or providing more guidance about how the auditor may deal with contradictory evidence when it is discovered in performing procedures, and prior to performing the overall evaluation of accounting estimates.<sup>39</sup>

- Make the application material in paragraph A101 applicable in all circumstances, not just for the risk factor of complexity.<sup>40</sup> Others noted that this application material takes the exercise of professional skepticism too far.<sup>41</sup>

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<sup>38</sup> *Regulators: UKFRC Member Bodies: NBA*

<sup>39</sup> *Firms: EYG, Member Bodies: SAICA*

<sup>40</sup> *Regulators: CEAOB, IFIAR*

<sup>41</sup> *NSSs: AUASB, Firms: GTI*