

Agenda Item 2-F.3

Analysis of Responses to Question 5 of the Exposure Draft

Section I: Question included in Exposure Draft

1. The following question was asked in the Exposure Draft:
 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?*
2. In responding to question 5, respondents also commented on the requirement in paragraph 19(b) of Exposure Draft of Proposed ISA 540 (ED-540)¹ and related application material. Those comments are summarized below.
3. Certain respondents also commented, at least in part, on this question in connection with their responses to questions 4 or 6, or as part of their general comments. Staff has integrated the comments relevant to question 5 in the analysis below.

Section II: Staff Analysis of Respondents’ Views²

Monitoring Group Responses

4. One Monitoring Group member³ indicated generally that the requirement in paragraph 20 of ED-540, along with the related application material, appropriately establishes how the auditor’s range should be developed.
5. One member of the Monitoring Group,⁴ suggested that the IAASB clarify that paragraph 20 applies in all instances when the auditor concludes that it is appropriate to develop an auditor’s range. Another member of the Monitoring Group⁵ indicated that more examples should be provided to address the application of paragraphs 19(b) and 20, particularly for audits of financial institutions.

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

² 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%.

³ *Regulators: IAIS*

⁴ *Regulators: IFIAR*

⁵ *Regulators: IAIS*

Developing an Auditor's Point Estimate or Using an Auditor's Range

6. One member of the Monitoring Group,⁶ suggested that additional guidance is needed to support the requirement in paragraph 20. The member of the Monitoring Group⁷ also expressed various concerns about the adequacy or clarity of the application material in paragraphs A128 to A134, and also recommended that additional guidance be provided in certain other areas. This respondent's suggestions included:
- a) With respect to paragraphs A128 to A134, clearer guidance on how to:
 - Set a reasonable range or threshold in testing management's accounting estimate;
 - Evaluate the variance between auditor's point estimate or range and management's accounting estimate and highlight the importance of investigating the underlying root causes of such variance (particularly when there is contradictory evidence from other audit procedures); and
 - Identify and evaluate errors, including extrapolation of errors to the relevant population and evaluating the risk of incorrect acceptance due to root causes of variances not being identified.
 - b) Further guidance and examples of the approach in paragraph A131 that allows the auditor to develop a point estimate or range for only part of the accounting estimate.
 - c) Address the issue of estimation uncertainty with populations containing a small number of high-value items (e.g., models for impairment of non-financial assets or recoverability of a single large disputed debt) compared to populations containing a large number of low-value items (e.g., a large number of small insurance contracts).
 - d) Recognizing that the term "reasonable" is used throughout ED-540 and that paragraph 20 requires the auditor's range to be reasonable when evaluating management's point estimate, more guidance and key considerations would be useful to facilitate the practical application of the term "reasonable."
 - e) Remind auditors to exercise professional skepticism in developing the reasonable range and not to set too wide of a range or threshold when auditing management's accounting estimate.
 - f) Stress the importance for auditors to be aware as to when it is appropriate to rely on their own range to evaluate the reasonableness of management's point estimate, and in which situations auditors need to undertake supplemental audit procedures.
7. With respect to paragraph A131, a member of the Monitoring Group⁸ believed that it that would be useful to highlight that, when the auditor uses management's model to develop a point estimate or range, the auditor first needs to test the operating effectiveness of relevant controls related to the model.

Evaluating the Reasonableness of Management's Point Estimate and Disclosures

8. Two members of the Monitoring Group,⁹ recommended that paragraph 19(b) and related application material be expanded to provide guidance on the auditor's responsibility for evaluating

⁶ Regulators: **IOSCO**

⁷ Regulators: **IOSCO**

⁸ Regulators: **IAIS**

⁹ Regulators: **BCBS, IAIS**

the point in the range chosen by management, when management has developed a range within which an accounting estimate may reasonably fall. In this regard, these respondents variously noted that:

- Although some financial reporting frameworks call for neutrality and do not specify whether any one point in the range is preferable to another, additional guidance would be helpful for the auditor's evaluation of indicators of potential management bias.¹⁰
 - The consideration of whether management's point estimate is appropriately representative of the range of reasonably possible measurement outcomes is included in paragraph A123, but is rather buried as the sixth bullet point in the list.¹¹
9. A member of the Monitoring Group,¹² suggested that the lead-in wording to the bullets in paragraph A123 should be stronger (i.e., "are" or "will be" relevant instead of "may be relevant").

General Observations

10. A majority of respondents¹³ indicated generally that the requirement in paragraph 20 of ED-540, along with the related application material, appropriately establishes how the auditor's range should be developed, often noting that this will be more effective or a better approach than the concept of "narrowing the range" in extant ISA 540.¹⁴ Respondents also commented on the need for additional guidance generally, or in specific areas as noted in the discussion of other points below.
11. A respondent¹⁵ did not support the proposed requirements in this area, encouraging the IAASB to focus on how to direct the auditor's work effort in relation to assessing the range or point estimate used by management. This would include ensuring that the auditor appropriately addresses the potential for management bias, confirmation bias and other factors that give rise to the concerns raised in relation to auditor's ranges determined under the requirements in extant ISA 540. Also see paragraphs 10 and 20 below.
12. A respondent¹⁶ did not believe that the proposed requirement in paragraph 20 of ED-540 and the related application material will achieve the intended objectives and may not result in fewer "overly broad" ranges. This respondent also noted that there has to be a reasonable basis to support the auditor's range, based on the evaluation of sufficient appropriate audit evidence, before concluding on an accounting estimate.
13. Some respondents¹⁷ suggested that the IAASB clarifies that paragraph 20 applies in all instances when the auditor concludes that it is appropriate to develop an auditor's range. A respondent¹⁸ noted that the placement of this requirement after paragraph 19(b) could lead to an assumption

¹⁰ *Regulators: BCBS*

¹¹ *Regulators: IAIS*

¹² *Regulators: IAIS*

¹³ *Regulators: IAIS, IRBA, UKFRC, NSSs: CAASB, CNCC-CSOEC, HKICPA, IDW, Firms: BDO, DTT, EYG, GTI, PKF, PWC, RSM, Public Sector: ACAG, AGA, AGC, CIPFA, GAO, INTOSAI, PAS, Member Bodies: AE, ANAN, CAI, CPAA, IAA, IBR-IRE, ICAG, ICAS, ICAZ, ICPAK, KICPA, SAICA, SMPC, Individuals & Others: NDEG*

¹⁴ *ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

¹⁵ *Member Bodies: ACCA-CAANZ*

¹⁶ *Member Bodies: AICPA*

¹⁷ *Regulators: IFIAR, UKFRC, NSSs: HKICPA, Firms: EYG, KPMG, Public Sector: ACAG*

¹⁸ *Regulators: UKFRC*

that it only applies when, in the auditor's judgment, management has not appropriately understood and addressed estimation uncertainty.

14. A respondent¹⁹ expressed a concern that auditors may not see the requirement in paragraph 20 and related application material as a significant change in practice, and recommended that the IAASB clearly emphasize the intent of paragraph 20 in the Basis for Conclusions.

Developing an Auditor's Point Estimate or Using an Auditor's Range

15. Many respondents²⁰ suggested that additional guidance is needed to support the requirement in paragraph 20, with some respondents²¹ suggesting more specific guidance on amounts that are "supported by the audit evidence." Other suggestions for additional guidance included:
- How to develop an auditor's range or point estimate;
 - When it may be more appropriate to develop a range instead of a point estimate;
 - Whether the preferred or recommended approach is to first consider a point estimate before developing a range;
 - How materiality affects these determinations; and
 - Which key considerations would be useful to facilitate the practical application of the term "reasonable."
16. Some respondents commented on the removal of the reference in extant ISA 540 to performance materiality in the context of narrowing the auditor's range, variously expressing:
- Support for the removal;²²
 - A preference to keep the reference or providing similar guidance,²³ or to provide more guidance when the auditor's range exceeds performance materiality.²⁴
17. Several respondents²⁵ supported the reference in paragraph A134 that, in certain circumstances, the auditor's range may be multiples of materiality for the financial statements as a whole. However, these respondents had various suggestions for revising or clarifying this paragraph, including:
- Explaining the basis for why the auditor's evaluation of the reasonableness of disclosures becomes increasingly important in these circumstances, instead of simply referring to the "importance" of such evaluation;²⁶
 - Noting that the nature of the uncertainty and the requirements of the applicable financial reporting framework will be relevant to considering the disclosures and also implications for the auditor's report;²⁷

¹⁹ *Regulators:* UKFRC

²⁰ *Regulators:* EBA, ESMA, **IOSCO**, *NSSs:* AUASB, NBA, *Firms:* BDO, GTI, KPMG, *Member Bodies:* ACCA-CAANZ, CPAA, ICAP, KICPA, SAICA, SMPC, IBRACON

²¹ *NSSs:* AUASB, NBA, *Firms:* BDO, DTT, PWC, *Member Bodies:* CAI, SMPC, *Individuals & Others:* NDEG

²² *Regulators:* UKFRC, *Individuals & Other:* CYGNUS ATRATUS

²³ *NSSs:* HKICPA

²⁴ *NSSs:* MAASB

²⁵ *Regulators:* UKFRC, *NSSs:* NZAuASB, *Firms:* EYG, KPMG, PKF, PWC, *Member Bodies:* AE, IBR-IRE, ICAEW

²⁶ *Firms:* EYG

²⁷ *Regulators:* UKFRC

- Moving the first sentence of A134 to the requirements,²⁸ or otherwise giving more prominence to this statement;²⁹ and
 - Considering the relationship to materiality for the financial statements as a whole.³⁰
18. Some respondents³¹ noted that ED-540 recognizes that, in certain circumstances, it may be difficult, or may not be possible, for the auditor to develop an independent point estimate or range (e.g., provision for expected credit losses). Points raised in this regard included:
- In these circumstances, the application material could clarify that the auditor should focus, among other things, on testing the relevant internal controls and the reasonableness of management’s point estimate, and that substantive procedures alone will not be sufficient;³²
 - ED-540 does not provide guidance on the auditor’s response in circumstances when management has not appropriately addressed estimation uncertainty and the auditor is unable to develop an independent estimate;³³ and
 - If management has not made the accounting estimate themselves, or does not have adequate processes to do so, it may not be practicable for the auditor to develop a point estimate or a supportable range. In those cases, a qualified or disclaimer of opinion may be appropriate because the auditor may simply not be able to obtain sufficient appropriate audit evidence about the accounting estimate.³⁴
19. Several respondents³⁵ questioned or expressed concerns about the statement in paragraph A128 that the auditor is designing and performing a substantive analytical procedure when developing an auditor’s point estimate or using an auditor’s range. Respondents variously noted that:
- The reference is confusing, could lead to unintended consequences, or should be deleted;
 - Developing an auditor’s point estimate or range is more akin to a test of details; and
 - If the reference is retained, provide additional guidance to better explain how an auditor’s point estimate or range is a substantive analytical procedure, or clarify the relationship to the requirements and guidance in ISA 520.³⁶
20. With respect to paragraph A131, a few respondents³⁷ suggested clarifying certain bullets.

Evaluating the Reasonableness of Management’s Point Estimate and Disclosures

21. Regarding paragraph 19(b), a few respondents³⁸ recommended that, before developing an auditor’s point estimate or range when management has not appropriately understood and

²⁸ NSSs: CNCC-CSOEC

²⁹ Member Bodies: AE

³⁰ Firms: PKF, Member Bodies: ICAEW

³¹ Regulators: EBA, Firms: GTI, KPMG, PWC, Member Bodies: AICPA

³² Regulators: EBA

³³ Firms: KPMG

³⁴ Firms: PWC

³⁵ NSSs: AUASB, CAASB, JICPA, Firms: BDO, GTI, KPMG, PWC, Member Bodies: AICPA, NASBA, SAICA, Individuals & Others: CYGNUS ATRATUS

³⁶ ISA 520, Analytical Procedures

³⁷ NSSs: HKICPA, Firms: BDO, Member Bodies: AE

³⁸ Regulators: EBA, ESMA, UKFRC

addressed the estimation uncertainty, the auditor should first request management to consider alternative assumptions or provide additional disclosures relating to the estimation uncertainty. A few respondents³⁹ noted that this would, in part, elevate paragraph A126 to a requirement, or recommended that it should be a requirement. Other related comments included suggestions to:

- Explicitly address the consequences on the auditor’s report and communication of key audit matters when management has not appropriately understood and addressed estimation uncertainty;⁴⁰
 - Emphasize that it is management’s responsibility to appropriately understand and address estimation uncertainty, and the auditor should focus on management’s response (also see paragraph 18 below);⁴¹ and
 - Link paragraph A125 to paragraph 19(b).⁴²
22. One respondent⁴³ recommended that paragraph 19(b) and related application material be expanded to provide guidance on the auditor’s responsibility for evaluating the point in the range chosen by management, when management has developed a range within which an accounting estimate may reasonably fall. In this regard, one respondent⁴⁴ noted that the IAASB could clarify that most frameworks refer to a representative figure in a range, rather than any number that could be at either end of the range, and that numbers are unlikely to be ‘representative’ at the outer ranges, particularly if all are equally probable. In such cases, the probability weighted estimate would be the mean and not the outer ranges.
23. A few respondents⁴⁵ suggested that the lead-in wording to the bullets in paragraph A123 should be stronger (i.e., “are” or “will be” relevant instead of “may be relevant”).
24. Several respondents⁴⁶ commented that the requirement in paragraph 19(b) and related application material in paragraph A127 could lead to concerns about the auditor assuming the responsibilities of management, or otherwise raise concerns about the auditor’s independence. In this regard, respondents variously noted that:
- The development by an auditor of a point estimate or range as a replacement for management’s point estimate or range may limit the exercise of professional skepticism and judgment and may be detrimental to audit quality;
 - The requirement may imply that it is the auditor’s responsibility to compensate for management’s ineffectiveness, and likely would result in the auditor concluding that control deficiencies exist and also could have other implications for the audit (e.g., changes to the auditor’s risk assessments, effect on the auditor’s report); and
 - The approach taken in ED-540 appears to put the burden on the auditor to develop a point estimate or range, as opposed to assessing whether management’s point estimate or range is reasonable.

³⁹ *Regulators:* ESMA, UKFRC

⁴⁰ *Regulators:* ESMA

⁴¹ *Firms:* KPMG

⁴² *Member Bodies:* CAQ

⁴³ *Regulators:* BCBS, IAIS, *Member Bodies:* ICAEW

⁴⁴ *Member Bodies:* ICAEW

⁴⁵ *Regulators:* IAIS, EBA

⁴⁶ *NSSs:* AUASB, *Firms:* KPMG, GTT, *Member Bodies:* ACCA-CAANZ, AE, CAQ, IBR-IRE, ICAEW, ISCA, *Public Sector:* AGNZ