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Dear Sir or Madame,

Response to the Exposure Draft (ED), International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

EFAA commends the IAASB on the proposed International Standard on Auditing 540 (Revised), [Auditing Accounting Estimates and Related Disclosures](#) ('ED-540'). We are pleased to provide our comments below, both 'General Observations' as well as 'Specific Comments' on the questions posed in the ED that have relevance to EFAA's constituency. Our comments have been compiled by EFAA's Assurance Expert Group.

About EFAA

The European Federation of Accountants and Auditors for SMEs ("EFAA") represents accountants and auditors providing professional services primarily to small and medium-sized entities ("SMEs") both within the European Union and Europe as a whole. Constituents are mainly small practitioners ("SMPs"), including a significant number of sole practitioners. EFAA's members, therefore, are SMEs themselves, and provide a range of professional services (e.g. audit, accounting, bookkeeping, tax and business advice) to SMEs. EFAA represents 17 national accounting, auditing and tax advisor organisations with more than 370,000 individual members.

General Observations

Overall the ED marks a significant improvement on the extant in terms of structure and understandability. We appreciate the effort undertaken to contain the length and complexity of the requirements' section and to ensure the standard is scalable. We welcome the proposed approach designed to ensure that accounting estimates assessed as low inherent risk to avoid being subject to onerous and inappropriate audit procedures. However, we suspect that many accounting estimates of SMEs will not be assessed as low inherent risk. A risk threshold alone is insufficient to guarantee scalability. Hence, we strongly recommend that the IAASB investigate how it might build further scalability into the standard. We also encourage the IAASB to consider including further SME examples into a separate staff publication focused on how the standard can be applied efficiently to smaller audits and the expected, modest, level of documentation.

Specific Responses to Questions Posed in ED

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

We recognize that one of the main motivations for this project is the adoption of [IFRS 9 Financial Instruments](#). EFAA research, [The Trickle Down Effect - IFRS and accounting by SMEs](#), revealed the existence of a trickle-down effect whereby accounting practices of larger entities, including those in IFRS 9, cascade down to the accounting practices of SMEs that are not required to apply IFRS. This effect means that auditing estimates will likely impact SMEs more than they might think. Indeed, our research revealed that there are many financial reporting frameworks, especially those based on or heavily influenced by IFRS, which 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 IR estimates apply to the audit of SMEs.

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

The requirements and application material appropriately reinforce the application of professional skepticism when auditing accounting estimates. We are, however, concerned from a scalability point of view as to how much evidence and documentation of effective challenges of management and exercise of skepticism regulators will expect of SME audits.

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

We welcome the IAASB's recognition of the need to seek standards that are scalable not least since many audits performed across Europe, our region of operation, are of simple SMEs. We are pleased to see the introduction of the threshold of low inherent risk. We suspect most accounting estimates in SME financial statements will be assessed as low inherent risk and this threshold will scope them out of the need for onerous procedures. However, many accounting estimates in SME financial statements will not fall within this threshold. Hence, we urge the IAASB to infuse further scalability in the approach when the inherent risk is not low. For example, ISA 540 could explicitly state that the three procedures listed for low inherent risk estimates (paragraph 15 (a)) may also be appropriate to other estimates.

Overall, we are concerned that ED-540 is over-engineered in some respects. While we appreciate the intent to avoid making significant changes in the audit of accounting estimates when inherent risk is low we feel the proposals give the impression that a substantial increase in work is required to assess the risk associated with many estimates. Auditors of SMEs will often calculate their own point estimate and simply compare it to the result provided by management without investing the time and effort to understand how management arrived at their estimate. The proposed standard now requires an understanding of what management did. In the case of SME audits this will likely mean additional work effort for no new evidence. We are therefore concerned about the additional documentation that will be needed for practitioners to demonstrate how they meet all the requirements, especially to satisfy inspectors. Consequently, we foresee additional cost and no corresponding benefit in terms of improved audit quality. Accordingly, we encourage the IAASB to clarify that the audit approach for accounting estimates classified as low inherent risk is unchanged.

The bifurcation of and understanding as to what is meant by "low" and "not low" is critical. Our hope is that in the case of SMEs "low" is interpreted as a broad category, perhaps to capture accounting estimates that many SMPs currently classify as "moderate". Hence it is essential for the IAASB to include greater clarification on what is meant by low inherent risk and the link between inherent risk and risk of material misstatement. It might help if the application material acknowledged that there's

considerable overlap between when inherent risk is low and ‘simple’ or ‘non-complex’ estimates and that the threshold should be at the higher end of complexity, judgment and estimation uncertainty.

Furthermore, we feel it would be helpful if the IAASB could provide more detail on the examples of estimates that might be considered low inherent risk, and those which are not, and how they might be dealt with under various scenarios. These SME examples might best be placed in a separate staff publication which could also explain how the standard can be applied efficiently to SME audits and the expected, modest, level of documentation.

We believe SME auditors may sometimes be in a position to identify accounting estimates with low inherent risk without having to perform all of the work steps required under the ED (para. 10). These steps seem excessive and unnecessary and deserve careful consideration as to whether they meet the criteria of scalability.

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?**

We believe, as stated above, that more should be done to achieve greater scalability when inherent risk is not low. While we appreciate the IAASB’s intent and efforts we believe the work effort is excessively prescriptive in each of the three areas and, as a result, fails to meet the criteria of objectives-based requirements and undermines scalability. We are concerned that the requirements as presented read as though practitioners would need to address all the matters and procedures. We challenge the IAASB to reconsider whether some of the requirements are more appropriate as application guidance. 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.

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 have no comments to make.

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 have no comments to make.

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?

We have no comments to make.

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 use of plain English should mitigate the risk of translators inadvertently changing the meaning of the original text.

(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.

We agree with an effective date set at around 18 months after approval. To aid implementation we recommend it be for a frequently used reporting date such as for financial statements for periods ending on or after December 15, 20XX.

I trust that the above is comprehensive but should you have any questions on our comments, please do not hesitate to contact me.

Yours faithfully,



Bodo Richardt

President