



**INTERNATIONAL AUDITING AND ASSURANCE STANDARDS
BOARD EXPOSURE DRAFT OF PROPOSED ISA 540 (REVISED),
AUDITING ACCOUNTING ESTIMATES AND OTHER RELATED
DISCLOSURES (ED-540)**

RESPONSE FROM ICAS TO THE IAASB

31 JULY 2017

Background

ICAS is a professional body for more than 21,000 world class business men and women who work in the UK and in more than 100 countries around the world. Our members have all achieved the internationally recognised and respected CA qualification (Chartered Accountant). We are an educator, examiner, regulator, and thought leader.

Almost two thirds of our working membership work in business; many leading some of the UK's and the world's great companies. The others work in accountancy practices ranging from the Big Four in the City to the small practitioner in rural areas of the country.

We currently have around 3,000 students striving to become the next generation of CAs under the tutelage of our expert staff and members. We regulate our members and their firms. We represent our members on a wide range of issues in accountancy, finance and business and seek to influence policy in the UK and globally, always acting in the public interest.

ICAS was created by Royal Charter in 1854.

General comments

We welcome the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB) Exposure Draft of International Standard on Auditing (ISA) 540 (Revised), Auditing accounting estimates and related disclosures, (ED-540).

The timing of the revised ISA is very relevant in response to proposed and imminent changes in the financial reporting environment, which are expected to place greater emphasis on the measurement and recognition of these accounting estimates, and the impact that these new reporting requirements are likely to have on the audit.

We acknowledge the IAASB's efforts to make ED-540 scalable however we do have some concerns over whether the desired level of scalability has been achieved and these have been highlighted in our responses to the Overall Questions below.

Finally, we welcome the introduction of the three relevant factors of complexity, the need for the use of judgement by management and estimation uncertainty. However, we believe that it is difficult to completely separate these three factors and that there is inevitably some degree of overlap and duplication between them. In our opinion, the most important of these factors is that of estimation uncertainty and believe that it will be present in all accounting estimates. Therefore, we believe estimation uncertainty should be presented as the overriding factor in relation to accounting estimates, with complexity and management judgement presented as possible additional factors.

Our detailed responses to the specific questions are set out below.

Overall Questions

Question 1

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

Response 1

We support the IAASB's attempts to update ED-540 to recognise the impact on the work of auditors of evolving financial reporting frameworks in so far as they relate to accounting estimates, most specifically the introduction of IFRS 9, Financial Instruments, but also new financial reporting standards on Leases, Revenue Recognition and Insurance Contracts. It is

helpful that the IAASB has also attempted to address the issue of the audit of disclosures in relation to accounting estimates in the exposure draft as such disclosures in certain instances need to be presented in greater detail to explain the basis and methodology behind the accounting estimate.

However, we believe that the increasingly complex financial reporting regime is relevant not only to auditors but also to preparers. Therefore, whilst we acknowledge the importance of the auditor's understanding of the applicable financial reporting framework, equal emphasis should be placed on the auditor's consideration as to whether management's estimate has been determined following management's appropriate understanding and application of the relevant financial reporting framework.

Question 2

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

Response 2

We are supportive of the approach that the IAASB has adopted in ED-540 and agree with the comment in the Executive Summary which states that the exposure draft contains some key provisions to enhance the way in which the auditor applies professional scepticism. We prefer the adoption of such a substantive approach than merely referring to the need for auditors to exercise professional scepticism at various parts of the proposed revised standard. However, as the regulatory community have been particularly vocal in the professional scepticism debate, there is a need to ensure that they appreciate the enhanced requirements within the proposed standard and how, if appropriately applied, they should enhance the manner in which the auditor applies professional scepticism.

One area where we believe further enhancement could be made is to include additional guidance in relation to how the auditor should evaluate qualitative disclosures to emphasise the need for the application of an appropriate level of professional scepticism. Such disclosures can be extremely important to allow the user to properly assess the uncertainty surrounding the recognition and measurement of certain elements of the financial statements. We would suggest that the Professional Scepticism Working Group considers this issue as part of their project.

Focus on Risk Assessment and Responses

Question 3

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

Response 3

We welcome the IAASB's recognition of the need to make ED-540 scalable to ensure that its requirements are proportionate for all audits. We do however have concerns over whether the desired level of scalability has been achieved.

Within our response we have used the term 'less complex entities' which will include a considerable number of, but not all, SMEs, as well as some larger, less complex, entities.

One particular area of concern is the inclusion of the section on the 'Risk assessment procedures and related activities' within paragraph 10 of ED-540. We are aware that ISA 540 establishes how ISA 315 should be applied specifically to accounting estimates, but, what is not clear, is how this will work in practice for less complex entities and, in particular, whether the requirements of paragraph 10 will need to be considered in addition to what is already required in ISA 315 when the risk of material misstatement in relation to accounting estimates is not significant.

As a result, we would welcome some clarification on the interaction between ISA 540 and ISA 315 in this respect. We believe that this is a particularly important issue as we are aware that ISA 315 is also currently under revision and failure to ensure that the intended relationship and interaction between these two standards is clear could lead to inconsistencies in the way the standards are interpreted and some significant conceptual challenges.

There may also be a need for greater clarification over the relationship between the level of significant risk, as referred to in paragraph 13 of ED-540, and the level of inherent risk in ED-540, i.e. 'low' or 'not low', and how this impacts on the work effort, as prescribed in paragraphs 14-20, and the extent to which it interacts with the requirements of ISA 330.

Additionally, from a practical perspective there may be other factors that will affect the successful implementation of this revised standard on the audits of less complex entities. For instance, in the UK, the new financial reporting regime has resulted in some of these less complex entities having to deal with more subjective valuations and, as a result, additional work is required by the auditors to verify these valuations. However, the risk of a misstatement in these subjective valuations might be insignificant in terms of the extent of external third-party interest in, or scrutiny of, these entities' financial statements. The revised standard could benefit from clear guidance on the extent of work effort that would fulfil the standard's requirements in such circumstances. We do accept that this is an issue that stems from the requirements of the financial reporting framework but it does have consequences for the audit.

We would also highlight that the examples provided of accounting estimates where the risk of material misstatement may be based on low inherent risk may not be the most appropriate (per paragraph A72). For example, we believe that there may be an increase in the risk of management bias where the profitability of the entity may directly impact upon the accounting estimate. i.e. management profit-related bonus, and, as a result, inherent risk is not low. To avoid any possible misinterpretation of these examples, we suggest that a statement should be inserted within paragraph A71 that emphasises the need for the auditor to consider the specific facts and circumstances of an accounting estimate before concluding as to whether the associated inherent risk is low or not low.

Finally, we would suggest that the wording in paragraph 15 (a) is clarified where it states "when inherent risk is low, the auditor shall determine whether one or more of the following further audit procedures would provide sufficient appropriate audit evidence regarding the assessed risk(s) of material misstatement". The use of the word 'whether' suggests to some that the auditor may choose not to do any further audit procedures but, to others, that at least one of the procedures should be performed. We recommend that the IAASB should clarify its intention on this requirement.

Question 4

When inherent risk is not low (see paragraphs 13, 15 and 17–20):

4(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?

4(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 estimation uncertainty?

4(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?

Response 4 (a)

We believe that it is difficult to completely distinguish between these three factors and that there is inevitably some overlap and duplication between the three definitions.

In our opinion, estimation uncertainty is the key factor present in all accounting estimates and complexity and the use of judgement by management subsets of this overriding factor, with the possibility that one, both or none of these additional two factors might also exist. Therefore, we would prefer to see estimation uncertainty listed as the key factor with the other two factors presented as possible additional factors. That might also help address the issue of duplication and overlap within the definitions.

Additionally, as stated earlier in this response, ISA 540 sets out how to apply ISA 315 to accounting estimates and reference to these three factors might make this identification and assessment process more effective.

Response 4 (b)

We support the requirement in ED-540 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 judgement by management and estimation uncertainty.

Response 4 (c)

We have not identified any additional guidance that should be included in the proposed objectives-based requirements in paragraphs 17-19 of ED-540.

However, we would suggest that paragraph 16, which refers to the auditor's reliance on controls, should be linked to paragraph 15(b) as this scenario will only be relevant when inherent risk is not low.

Finally, we would suggest that the term 'significant data', referred to in paragraphs 17-18, should be defined and included within the definitions section on page 31 of ED-540.

Question 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?

Response 5

We believe that the requirement in paragraph 20, and the related application material in paragraphs A128 – A134, should provide greater clarity and consistency for the auditor in the development of a point estimate or use of an auditor's range. In particular, we welcome the decision to remove the requirement for the auditor to 'narrow the range until all outcomes within the range are considered reasonable'. We believe that this requirement lacked clarity and could result in a range that was inappropriately wide. That said, we do believe that the planned field testing exercise will help determine whether this is a better approach.

Question 6

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?

Response 6

We believe that the requirement in paragraph 23 and related application material should result in more consistent determination of a misstatement, including when the auditor uses an auditor's range to evaluate management's point estimate. However, we would propose that the term 'reasonable' when used to describe disclosures in paragraph 23, should be replaced by 'adequate' to be consistent with the wording agreed during the IAASB's disclosures project when referring to disclosures.

As per our response to question 2 above, one area where we believe further enhancement could be made is to include additional guidance in relation to how the auditor should evaluate qualitative disclosures. In relation to certain accounting estimates such disclosures are extremely important to allow the user to properly assess the uncertainty surrounding the recognition and measurement of certain elements of the financial statements.

Conforming and Consequential Amendments

Question 7

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?

Response 7

We believe that the proposed conforming and consequential amendments to ISA 500 regarding external information sources, and the revision to the requirement in paragraph 7 and the related new additional application material, should result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources.

Request for General Comments

Question 8

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.
- (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.

Response 8 (a)

We have not identified any potential translation issues.

Response 8 (b)

We agree that an appropriate effective date for the standard would be for approximately 18 months after the approval of a final ISA and that earlier application should be permitted and encouraged. Although it is regrettable that the revised ISA 540 will not be published ahead of IFRS 9 coming into force, we believe that the ultimate objective should be the development and issue of an auditing standard of the highest quality and this should not be sacrificed in order to meet an earlier deadline.

We would also reiterate the comments in our response to question 3 that, given the interaction between ISA 540 and ISA 315, it is important that any anticipated revisions to ISA 315 that are likely to impact upon ISA 540 are properly considered and reflected before the revised ISA 540 is finalised.