July 31, 2017

Mr. Matthew Waldron
Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue
New York, NY 10017

Re: Exposure Draft: Proposed International Standard on Auditing (ISA) 540 (Revised), ***Auditing Accounting Estimates and Related Disclosures*** **(ED 540)**

Dear Mr. Waldron:

The American Institute of Certified Public Accountants (AICPA) Auditing Standards Board (ASB) is pleased to respond to the International Auditing and Assurance Standards Board' (IAASB) above referenced exposure draft.

The AICPA is the world's largest member association representing the accounting profession, with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. AICPA members represent many areas of practice, including business and industry, public practice, government, education, and consulting. Among other things, the AICPA sets ethical standards for the profession and U.S. auditing standards (generally accepted auditing standards or GAAS) for private companies, nonprofit organizations, and federal, state and local governments (nonissuers). As set forth in the Explanatory Memorandum to ED 540 (Explanatory Memorandum), ED 540 proposals are intended to modernize extant ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, for the following reasons:

- The anticipated auditing challenges arising from the new international accounting standard, International Financial Reporting Standard (IFRS) 9, *Financial Instruments*,
- Management's increasing use of external information to make estimates, and
- The ongoing criticism of auditors' inadequate assessment of risks of material misstatement by not considering inherent risk factors such as increased complexity of business environment, increased use of information technology, and large amounts of data. Criticism cited also included inadequate control risk assessments. The criticism of inadequate assessment of risks of material misstatement resulted in inadequate design and execution of further audit procedures, thereby resulting in a failure to obtain sufficient appropriate audit evidence.

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In the Explanatory Memorandum, the IAASB describes its extensive outreach activities, which included consulting with the U.S. Public Company Accounting Oversight Board (PCAOB), in the development of ED 540. The PCAOB recently released for exposure its Proposed Amendments to Auditing Estimates, Including Fair Value Measurements (PCAOB Proposal). While the ASB's focus is on the development of auditing, attestation, and quality control standards for nonissuers, our strategy also considers PCAOB standards in an effort to minimize unnecessary differences for auditors of nonissuers, particularly when the identified differences improve professional standards. We note that the PCAOB Proposal is closely aligned with extant ISA 540, while also proposing enhancements targeted at improving audit execution and quality. We believe that the PCAOB Proposal contains proposed requirements that may address the issues we have identified with ED 540. We urge the IAASB to continue its outreach activities with the PCAOB with the goal of achieving closer convergence.

While we are supportive of the IAASB's project to enhance extant ISA 540, we believe that significant changes to ED 540 are necessary before it should be finalized, specifically in the following areas:

- Connectivity of ISA 540 to other ISAs; in particular, ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*
- Clarity of the ED 540 requirements related to the proposed standards
- Work effort and scope of ED 540

For the IAASB's consideration, we have provided our overall comments in the following section. In the appendix to this letter, we have provided our specific responses to the questions presented in ED 540.

Overall Comments

In our jurisdiction, deficiencies in auditing accounting estimates continue to be a common inspection finding identified by regulators. Examples of such deficiencies include failures to sufficiently (i) test data used by companies to develop accounting estimates, (ii) evaluate the reasonableness of significant assumptions used by management, (iii) understand information provided by third-party pricing sources, and (iv) obtain an understanding of the process for determining fair value measurements in audits of brokers and dealers. These inspection observations continue to raise concerns about auditors' application of professional skepticism and consideration of the potential for management bias in accounting estimates.

Therefore, while we recognize the need to evaluate the efficacy of ED 540 for these reasons, we would be supportive of the IAASB making targeted amendments to extant ISA 540 to address these inspection findings and observations rather than overhauling the entire standard. We also believe such enhancements would be relevant to and address further changes in financial reporting frameworks, most notably those related to recognition of revenue and accounting for expected credit losses (as set forth in IFRS 9).

This section highlights our overall comments, which will then be explained in further detail in our response to the questions.

Connectivity to Other ISAs

While we agree with the IAASB's reasons to modernize extant ISA 540, we believe that it would be more appropriate for many of the proposed changes to be a result of:

- enhancements to the overall risk assessment process,
- clarity regarding circumstances when substantive procedures alone will not provide sufficient appropriate audit evidence, and
- the relevance and reliability of internal and external data

We understand that most of these suggestions are being addressed as part of the IAASB's ISA 315 (Revised) project and, eventually, the ISA 500, *Audit Evidence*, project. We are concerned that adopting changes to risk assessment and evaluation of evidence in such a narrow focus will result in these changes being subject to revisions as the new projects are developed.

Accordingly, we believe that a targeted amendment should focus on providing auditors with an explicit linkage between ED 540 and the risk assessment standards, ISA 315 (Revised) and ISA 330, *The Auditor's Responses to Assessed Risks.* These ISAs represent the foundational standards underpinning an audit, and as a special considerations standard, extant ISA 540 is intended to build upon, not replace, those foundational standards; this point is not clear enough in ED 540. One could draw the conclusion that a separate assessment and related documentation of the matters related specifically to estimates would be required, which could result in a redundant, inefficient approach.

Clarity of the ED 540 Requirements

We found that the construct of the requirements in ED 540 is overly complex and expect it will be difficult for auditors to effectively apply. While we agree that, as stated in paragraph 4 of ED 540, complexity, judgment, and estimation uncertainty are interrelated, we believe that these factors exist for all accounting estimates, albeit to varying degrees. Consequently, we think that the requirements, as written, may result in inappropriate audit response and potentially inappropriate auditor behavior (for example, using the requirements of ED 540 as support for not performing certain procedures). We cannot envision many instances where all three factors (complexity, judgment, and estimation uncertainty) would not be relevant to some extent. Rather, the auditor should focus on the scalability of the factors (for example, the risks of material misstatement might not be in complexity of the calculation but in the underlying data and the subjectivity of selecting the information).

We recognize the potential benefits of enhancing professional skepticism by specifically considering the three underlying risk factors. However, because the risk factors are interrelated and not mutually exclusive, we are concerned that the requirement in ED 540 for the auditor to separately assess and respond to each of these three risk factors on each accounting estimate could lead to excessive work effort that is duplicative and not targeted directly towards the work effort that will mitigate the risk. An unintended consequence might be that the auditor will be focused on duplicative consideration and documentation around the assessment of the three risk factors rather than taking a more holistic view of the estimate and the risks of accuracy of the accounting estimate, the sufficiency of the related disclosures, and addressing the risks of material misstatement. Finally, we note that certain of the matters included in those factors would be relevant to the estimates deemed “low” inherent risk—that is, the matters are not exclusive to the approach for addressing “not low” risks. We believe this should be made clearer in ED 540.

Work Effort and Scope

At the core of all accounting estimates are assumptions, underlying data, a calculation, and estimation uncertainty that are inherent when predicting future events. We believe that ED 540 does not sufficiently address the disaggregation of accounting estimates into these components. This is important because each different component may be subject to significantly differing risks of material misstatement. The auditor’s responses should include procedures that are responsive to the differing risks of material misstatement.

We believe that paragraphs 26(d) and 28 of the Explanatory Memorandum provide very helpful guidance on the proposed work effort to audit accounting estimates. We recommend that these paragraphs be incorporated into ED 540 as application material, especially if the IAASB decides to retain the approach in paragraphs 17–19 of ED 540.

We are concerned that the guidance in ED 540 targeted to smaller entities may not be appropriate. The size of an entity or an audit firm should not be a determining factor in assessing the risks of material misstatement of an accounting estimate. Instead, the work effort should be driven by the risks of material misstatement related to the specific components of the estimate. Because accounting estimates with higher risks exist even in smaller entities, the current approach and related guidance for audits of smaller entities may lead some to believe that the expected level of work may be lower for a smaller entity even though the risks of material misstatement may be higher.

ED 540 bifurcates the work effort between accounting estimates assessed as “low” inherent risk and those assessed as “not low” inherent risk. We believe that this bifurcation is confusing and will not achieve the desire to address the scalability of ED 540. This is because it is not clear how the responses under the “low” inherent risk interrelate with the responses under the “not low” inherent risk. For example, the requirements in paragraph 15(a) of ED 540, which are designed for accounting estimates with “low” inherent risk, would be applicable to audits of all accounting estimates. Many of the procedures in paragraph 17 of ED 540 would likely need to be part of the auditor’s approach to testing how management made the accounting estimate (paragraph 15(a)(ii) of ED 540) and the data on which it is based—even if the estimate has been assessed as “low” inherent risk. When the estimate’s inherent risk is “not low,” we believe that the approaches to audit an estimate would be the same (that is, the strategies for testing estimates in extant ISA 540)—but that in accordance with ISA 330, the auditor would be obtaining more persuasive evidence the higher the auditor’s assessment of risk.

The Way Forward

Therefore, we strongly recommend that the IAASB reconsider the proposed approach of having two separate paths of addressing risks of material misstatements for estimates. We believe ED 540 should include an approach similar to extant ISA 540—that is, to test all accounting estimates within the context of the focused areas of risk (complexity, judgment, and uncertainty), scaled to clearly explain that as the risks of material misstatement increases, the auditor would be required to obtain more persuasive audit evidence. The application material could then further explain the challenges of auditing more complex accounting estimates such as those recorded under the expected credit loss model, including specific considerations where judgement could be affected by management’s bias, and so on.

Finally, we recommend that several of the concepts in the appendix be reconfigured as an International Auditing Practice Note (IAPN) that could be issued to provide more detailed guidance to assist in the implementation of the revised ISA.

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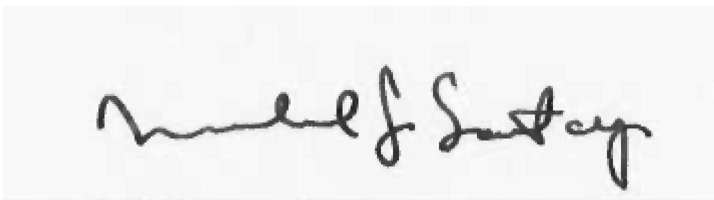
Thank you for the opportunity to comment on this exposure draft. If you have any questions regarding the comments in this comment letter, please contact me at Mike.Santay@us.gt.com or Hiram Hasty at Hiram.Hasty@aicpa-cima.com.

Respectfully submitted,



/s/ Michael J. Santay

Chair, Auditing Standards Board

Appendix

Responses to ED 540 Questions

Question 1: Has ED 540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?

Response: Accounting estimates are prevalent in financial reporting and often have higher risks of material misstatements for reasons cited in ED 540. We acknowledge that evolving financial reporting frameworks, for example, IFRS, often require management to modify an entity's financial reporting processes to address more complex accounting principles such as those accounting principles that will be required under IFRS 9. However, we believe that ISAs should be scalable to audit risk and how entities operate while remaining framework neutral. We are concerned that driving more prescription into the ISAs to allay concerns around application to a specific standard is not appropriate and could result in multiple future amendments as reporting frameworks change.

While we believe that the existing requirements in extant ISA 540 are sufficient for addressing the misstatement risk related to estimates for most audits, we do believe that certain additional application material could be provided in light of significant changes in the way entities operate, such as increasing the use of technology, volumes of data, and the increased use of forward-looking information being required by financial reporting frameworks. Additionally, as mentioned earlier, we also would support targeted changes such as those proposed by the PCAOB, especially in the area where specialists are used.

In order to address concerns over changes in the reporting frameworks, we are supportive of alternative approaches such as continued or expanded use of IAPNs to provide specific industry guidance for audits of financial institutions and other entities where the expected credit loss model will likely impose significant accounting changes, as one example. We believe the flexibility in guidance will be needed, particularly when looking through the changes with an industry-specific lens.

Question 2: Do the requirements and application material of ED 540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?

Response: Yes. We generally support the proposed amendments in ED 540 that reinforce professional skepticism when auditing accounting estimates. Those have been put forth as (1) the enhanced risk assessment requirements, (2) more granular requirements for higher inherent risk estimates, and (3) the stand back provision. We are also supportive of the IAASB's efforts with respect to exploring ways in which professional skepticism can be embedded in the ISAs and are aware of the IAASB's project addressing professional skepticism. However, with respect to the three areas of focus, we have noted certain concerns about how those are operationalized (noted elsewhere in this letter) and would suggest that the IAASB can achieve certain objectives through the approach of adding additional requirements, but strongly caution the Board that adding more requirements does not always equate to driving higher professional skepticism.

Question 3: Is ED 540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?

Response: We believe that addressing scalability by proposing audit objectives dependent on the assessment of two categories of inherent risk, with differing requirements within these categories, will result in an ISA that is overly complex. Paragraphs 10–15 of ED 540 will be difficult for auditors to effectively apply for the following reasons:

1. With respect to the three risk factors contributing to inherent risk in ED 540 (complexity, use of judgment, and estimation uncertainty), we have the following concerns:

    a. The Explanatory Memorandum suggests that the ED 540 introduces “an enhanced risk assessment” by including new factors that would inform the inherent risk in accounting estimates, yet most of the factors exist in extant ISA 540. We believe that geographically including the risk assessment in ED 540 instead of ISA 315 (Revised) is confusing and may be a deterrent to audit quality.

    b. We believe that the distinction among the three risk factors may not be operational or beneficial in performing the audit and, instead, suggest a focus on the components of all accounting estimates—data, assumptions, a calculation, and estimation uncertainty. We believe matters related to complexity and judgment are closely related to the components listed above and could be part of the considerations related to assessing risks, including, for example, management’s addressing of estimation uncertainty through use of alternative models, more precision in judgments around assumptions, and so on. We acknowledge that the intention of the IAASB might not be to have auditors classify the estimates according to the three risk factors but, rather, to help the auditor in determining the nature of the risks, and then focus the auditor’s work on those risks accordingly. If that is the intent, we recommend that this intent be made clearer in ED 540, including clarity that all three factors will generally be applicable. The scalability should be in the performance of procedures within each risk factor, not whether the factor applies.

    c. Moreover, use of these three risk factors as part of considering inherent risk, without a clear linkage to ISA 315 (Revised) where these factors are first introduced, makes it seem like new terminology rather than an application of existing risk assessment concepts.

2. As drafted, we believe the assessment of inherent risk in paragraph 10 of ED 540 could be read as a separate risk assessment from what is required under ISA 315 (Revised) because, as proposed, it would seemingly require the auditor to separately understand management's estimates without a clear linkage in the requirements or application material to how the risk assessment in ED 540 is integral to the risk assessment for the financial statements taken as a whole. Paragraphs 25–27 of ISA 315 (Revised) discuss that the risk associated with accounting estimates is in the context of classes of transactions, account balances, and disclosures in identifying and assessing the risks of material misstatement at the financial statements and assertions levels, including the identification of whether any of the assessed risks are significant risks. Yet, paragraphs 10(e)–(f) of ED 540 seemingly apply separately to each individual accounting estimate made when preparing financial statements without consideration of risk or materiality. Because the changes are set out in ED 540 rather than ISA 315 (Revised), we believe, as drafted, this ostensibly creates another layer of risk assessment because some of the requirements in ED 540, as drafted, may be interpreted to be read in isolation and not in combination with the requirements in other ISAs.

   An example of the inconsistency is paragraph 10(e) of ED 540, which is inconsistent with paragraph 18(e) of ISA 315 (Revised). Paragraph 18(e) of ISA 315 (Revised) requires the auditor to understand the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures, while paragraph 10(e) of ED 540 can be interpreted to refer to all accounting estimates.

3. We acknowledge that the retrospective review described in paragraph 11 of ED 540 exists in extant ISA 540, with certain exceptions. However, we do not believe that this requirement should be applicable to all estimates, only for those, as noted in extant ISA 540, "whether the information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the *current period* [emphasis added] financial statements." For example, for accounting estimates with "long tails" such as actuarial liabilities, it is difficult to understand what, specifically, is the extent of work required by the auditor with respect to a retrospective review and to what extent any differences should be investigated. Without further clarification, we do not believe there will be consistent understanding of what is expected and at the level of granularity of performance that would be required.

4. ISA 315 (Revised) requires the assessment of the risks of material misstatement at the overall financial statement level and at the assertion level, including whether any of the risks identified are significant risks. We recommend that the IAASB be clear that the assessment of inherent risk referred to in ED 540 is part of the assessment of inherent risk already required in ISA 315 (Revised). Additionally, until the IAASB completes its risk

assessment project, we recommend that ED 540 be consistent in its approach that the design of further audit procedures is based on the assessed risks of material misstatement as described in existing ISAs.

5. ED 540 is not clear as to whether the assessment of inherent risk should be made at the relevant assertion level as required by ISA 315 (Revised) and does not provide guidance as to what the relevant assertion might be. Rather, it refers to accounting estimates as if they are separate from classes of transactions, account balances, and disclosures used in both ISA 315 (Revised) and ISA 330. Providing guidance on identifying the relevant assertions will likely improve audit quality when it is better expressed in terms of the assertions to which the risks of material misstatement specifically relate (for example, valuation, completeness, or accuracy).

6. With respect to the assessment of inherent risk as "low" or "not low," we are not supportive of the proposed approach for the following reasons:

    a. We believe auditors will expend unnecessary effort determining what is meant by "low" inherent risk, and when considered with the related application material in paragraph A72 of ED 540, few accounting estimates may be assessed as "low" inherent risk. We think the construct of extant ISA 540 is already scalable based on risks of material misstatement. Further, we contend that guidance in extant ISAs already recognize that estimates are either higher or have greater inherent risk. For example, paragraph 27 of ISA 315 (Revised) requires the auditor to determine whether any of the risks identified are, in the auditor's judgment, significant (without consideration of controls).

    b. We believe that some auditors may infer that the "low" and "not low" assessment of inherent risk represents the only scalability of ED 540 and then fail to recognize that the nature, timing, and extent of audit responses within the "not low" category will also vary according to the assessed risks of material misstatement. Instead of using these two categories to address the issue of scalability, we recommend that a more explicit and clearer link to ISA 315 (Revised) and ISA 330 be made. In other words, the auditor's work effort in auditing accounting estimates remains based on the assessment of the risks of material misstatements, and the design and responses remains based on the assessed risks already required in ISA 315 (Revised) and ISA 330, respectively, with enhanced application guidance provided in areas of higher risk of material misstatement. This approach would help clarify that ED 540 is not a standalone standard but, rather, is incremental to the fundamental risk assessment in an audit already required under ISA 315 (Revised). However, we recognize that additional application material (and implementation guidance such as an IAPN) is needed to address audit challenges arising from more complex accounting estimates, such as those recorded using the expected credit loss model.

c. The proposed requirement will force auditors to make a separate assessment of inherent risk. ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With International Auditing Standards,* allows the auditor to make a combined assessment of risk of material misstatement, which is comprised of inherent risk and control risk. Moreover, the focus of other ISAs has typically been on audit response to "higher" or "increased" risks of material misstatement, which we believe is understood in practice.[1]

7. With regard to paragraph 13 of ED 540, the differentiation between complexity, judgment, and estimation uncertainty will be difficult to implement for the following reasons:

   a. Most accounting estimates have some level of estimation uncertainty unless the accounting estimate is settled shortly after the reporting date. It will be difficult to determine whether an accounting estimate will be settled at the planning stage, so an interpretation of ED 540 is that consideration of estimation uncertainty would be applicable in all circumstances in varying degrees. It would generally be difficult to say that estimation uncertainty did not contribute to a risk assessment of "not low." Therefore, we are concerned that significant work effort will be unnecessarily dedicated for accounting estimates settled at the planning stages simply because of an inability to plan for settlement in the planning stages of the audit. Furthermore, it is unclear how the auditor may address this situation without incurring the work effort described in paragraphs 14–19 of ED 540 in these situations.

   b. As proposed, there would likely be questions and inconsistent application as it relates to the audit documentation required with respect to the assessment of which elements are contributing to the "not low" inherent risk assessment. Questions that this approach raises include:

      "Is there a presumption that each of the elements (complexity, judgment, and estimation uncertainty) do contribute, and the auditors should document their considerations with respect to why a particular element does not?"

      "Would the auditor only be required to document the considerations that they deemed to be present?"

[1] Paragraph A40 of ISA 200 uses "higher;" paragraph A141 of ISA 315 (Revised) uses "greater;" paragraph A10 of ISA 330 uses "lower."

There is a concern that there would be extensive documentation requirements for these factors that, ultimately, would not necessarily assist the auditor in the design and performance of the appropriate responses.

8. Paragraph 15 of ED 540 retains the concept that events occurring up to the date of the auditor's report may constitute sufficient appropriate audit evidence in auditing an accounting estimate for use when inherent risk is "low." We have the following concerns with this requirement and related application material:

    a. With regard to the three testing strategies when inherent risk is "low," we recommend retaining them in ED 540 regardless of the assessed inherent risk. As currently drafted, all the application material on how to effectively apply the strategies has been deleted. Arguably, the three testing strategies and related application material are what is applied in all substantive procedures. The auditor either tests how management records transactions, including inspection of internal or external evidence, tests the settlement of transactions, or develops expectations to compare to management's balance.

    b. We agree that if the outcome of uncertainty becomes known before the date of the auditor's report, estimation uncertainty risk assessment may be revised. However, ED 540 does not adequately address considerations for considering the relevancy of the subsequent event. For example, an entity may sell an investment security for $100 in late January (an event subsequent to the balance sheet date that was not necessarily indicative of fair value at that date) and uses that value as an estimate of value at December 31. Paragraph 15(a)(i) of ED 540 should be rewritten to require the auditor to consider whether the subsequent transaction is relevant to the estimate or indicative of changes in market conditions.

       Also, we believe the requirement should be explicit as to whether the auditor is expected to perform the risk assessment procedures in ED 540 when the auditor expects to obtain sufficient appropriate audit evidence from events occurring up to the date of the auditor's report. We do, however, note that there is a risk that if subsequent events do not provide the necessary audit evidence as expected, there could be significant challenges in going back to perform the risk assessment procedures not considered when planning the engagement.

    c. As drafted, this requirement may be overly complicated for auditing simple accounting estimates. For example, we believe there are circumstances in which analytical procedures would provide sufficient appropriate audit evidence in auditing an accounting estimate (for example, in testing depreciation expense for routine annual property and equipment additions).

d. For some accounting estimates, determining whether events occurring up to the date of the auditor's report provide audit evidence (that is, testing the outcome of an accounting estimate) may be the most effective and efficient way of obtaining sufficient appropriate audit evidence (that is, in some circumstances this may be highly persuasive and sufficient evidence). Based on how ED 540 is drafted, incremental procedures could be read as being required to be performed if the risk assessment was influenced by one or more of the three factors, increasing the audit effort with potentially little benefit. Guidance in paragraph A75 of ED 540 indicates that the auditor could revise inherent risk after the outcome becomes known, but we question whether the focus should instead be on the sufficiency of evidence.

Question 4: When inherent risk is not low:

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 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?

c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17–19 of ED 540? If not, what additional guidance should be included?

Response: No. As mentioned in our response to question 3 above, we believe that the construct in ED 540 is overly complex and will create confusion in practice. Our main concerns with respect to when the assessment of inherent risk is "not low" are as follows:

1. Extant ISA 540 has always been and should continue to be about how ISA 330 is applied when auditing accounting estimates.[2] We further believe that paragraphs 17–20 of ED 540 were aimed at providing the auditors with considerations and not mandating specific requirements. We found it difficult to reconcile paragraph A97 of ED 540 with paragraphs 17–20 of ED 540. Specifically, how does obtaining audit evidence about events occurring up to the date of the auditor's report, or developing a point estimate or range based on available audit evidence to evaluate management's point estimate, interrelate with the requirements in paragraphs 17–20 of ED 540?

2. We have the following concerns with paragraph 15 of ED 540:

[2] Paragraph A69 of ISA 200.

a. While auditors are already required to evaluate identified risks of material misstatements to determine if those risks of material misstatements represent a significant risk, which is based solely on inherent risk, the requirement in paragraph 15 of ED 540 to identify whether inherent risk is “low” or “not low” seems to introduce a new risk assessment criterion. It is not sufficiently clear whether an inherent risk that is “not low” is the equivalent of a significant risk. We believe that the intent is that inherent risk that is “not low” captures other risks along the inherent risk spectrum, and it should be clarified in ED 540.

b. While attempting to retain the extant testing strategies, the application material and specific requirements are not in ED 540. It is not sufficiently clear as to whether, when testing how management made the accounting estimate as required by 15(a)(ii), the auditor would be also required to obtain specific evidence as to the data, assumptions, and calculations. We believe it is important for ED 540 to be clear as to how the testing approaches interact with the risks identified related to the components of the estimate (including how complexity and judgments impact the risks of those estimates). The ED is not clear on this interaction.

c. With regard to paragraph 15(a)(iii) of ED 540, we do not understand the difference between the requirement in this paragraph to develop a point estimate or range based on available audit evidence to evaluate management’s point estimate, and the requirement in paragraph 19(b) of ED 540 for the auditor to develop an auditor point estimate or range to evaluate the reasonableness of management’s estimate, when management has not sufficiently addressed uncertainty.

d. The intent of paragraph 15(b) of ED 540 is not clear as to whether it is trying to express the notion that auditors may use a blended approach (of the three basic audit strategies) when inherent risk is “not low.” We believe that the revised ISA should be explicit regarding the fact that auditors <u>may use a combination of multiple approaches</u> to obtain sufficient appropriate audit evidence. When considered in concert with our other recommendations, we recommend simplifying paragraph 15 of ED 540 to clarify the auditor’s response regardless of the level of assessed inherent risk, as follows:

    i. The auditor should use one or more of the three testing strategies to obtain sufficient appropriate audit evidence that is responsive to the risk(s) of material misstatement in the circumstances. Audit evidence may be the result of substantive procedures alone or a combination of substantive procedures and tests of controls, but may not be based solely on evidence from testing of controls.

ii. As the risk of material misstatement increases as a result of the inherent risk assessment, the auditor should identify the sources of risk (for example, data, significant assumptions, or complexity of calculations, including models), and design an audit response to the assessed risks that achieves the relevant objectives as currently drafted in paragraphs 17–20 of ED 540, most of which are likely to be relevant.

iii. The auditor's documentation of further audit procedures clearly should demonstrate how the audit evidence obtained is appropriately persuasive to the assessed risk of material misstatement.

3. Paragraph 16 — An underlying theme of ED 540 is testing data integrity, particularly when using forward-looking information and the importance of considering the related controls over the data, especially with regard to auditing accounting estimates. Paragraph 26(e) of the Explanatory Memorandum indicates that the IAASB chose to develop an approach to reinforce the need to test the operating effectiveness of controls when the auditor intends to rely on those controls or when substantive evidence alone cannot provide sufficient evidence. We believe paragraph 16 and the related application material in ED 540 are insufficient to assist auditors in recognizing the circumstances in which, in today's environment (for all industries, not only those cited in paragraph A98 of ED 540), sufficient appropriate evidence cannot be obtained for the elements of the estimate (for example, the model(s) or the data source(s)) without testing controls. Without changes to ISA 315 (Revised), ISA 330, or ISA 500 to address the overall issue of obtaining an understanding of internal control, including control activities or the design and responses to assessed risks, including when substantive procedures alone do not provide sufficient appropriate audit evidence, we believe that ED 540 and the conforming amendments to ISA 500 will not be well understood and may create confusion and inconsistent application in practice. We do appreciate certain aspects of the PCAOB proposal, which is also aimed at enhancing auditor performance in relation to accounting estimates but reinforces the need to understand controls related to estimates and drivers as part of risk assessment in Auditing Standard (AS) 2110, *Identifying and Assessing the Risks of Material Misstatements*. We recommend the Board reconsider this approach in addressing this important area.

4. With regard to paragraphs 17–18 of ED 540, we believe that as drafted, these paragraphs contain excessive duplication and should be combined. For each of the matters listed in the combined paragraph, indicate whether the matter relates to complexity, judgment, or both. In addition, we have the following concerns on these paragraphs:

   a. There is little guidance on how to actually test management's process; that is, what procedures may be performed (for example, how the auditor may comply with paragraph 17(c)) of ED 540. The guidance on the testing strategies from extant ISA 540 is necessary and likely should be expanded.

b. As mentioned in the overall comments, it is not clear how ED 540 is intended to be applied in connection with ISA 330 and whether there are other assertions in an accounting estimate, other than the valuation assertion, that are subject to ISA 330. We further believe that, for example, paragraph 17 of ED 540 discusses the procedures performed on significant assumptions and data, but it is not clear whether additional work should be done in accordance with ISA 330 on assumptions and data that are not significant.

c. There is little guidance on what is considered significant data and assumptions. The term "significant data" may not be intuitive as data is usually a fixed set of information against which assumptions are applied. We are unclear as to how the auditor would determine what data would not be tested and how significance would be assessed. Because it might be confusing to use the term "significant data" in conjunction with significant assumptions, we suggest using "key factors" (see paragraph .09 of extant AS 2501, *Auditing Accounting Estimates*, of the PCAOB standards).

d. Paragraph 18(c) of ED 540 is unclear about how these requirements relate to the standards dealing with the use of experts (ISA 620, *Using the Work of an Auditor's Expert*, and ISA 500 specifically, using evidence prepared by a management's expert). For example, does the auditor (or an auditor's specialist) need to have an in-depth understanding of an actuarial model developed by management's actuarial specialist?

5. With regard to paragraph 19 of ED 540, because estimation uncertainty is inherent in all accounting estimates and, in fact, is in the definition of an accounting estimate, it should not be considered as a separate risk factor. Further, we believe that paragraph 19 of ED 540 provides no incremental work to what is required by paragraph 17–18 of ED 540, and the guidance with respect to estimation uncertainty creates unnecessary duplication. Thus, we suggest that paragraph 19 of ED 540 be deleted. Further:

   a. In paragraph 19(a)(ii) of ED 540, because disclosure requirements related to estimation uncertainty are fairly limited in the accounting standards, we are concerned this requirement may inadvertently be creating an accounting disclosure requirement in the ISAs that affect all estimates more broadly. We note the same concern with paragraph 21 of ED 540. While we are supportive of the notion that additional disclosures are often critical for users to understand estimation uncertainty, for example, we believe the requirement could be more specific to estimates with higher risks (extant ISA 540 requires this for significant risks). We recommend a more refined approach that would focus the assessment of disclosures in those areas of higher risk.

b. With respect to the auditor developing an independent estimate in paragraph 19(b) of ED 540, we believe that the ED should not take an approach whereby the auditor is required to develop a point estimate or range when management has not properly addressed estimation uncertainty. In practice, this requirement will be very difficult to complete as the auditors would be tasked with applying their own judgment in place of management's judgment and may not have sufficient information to do so. While ED 540 seems to acknowledge the difficulty, it does not offer an alternative course of action when developing an auditor's estimate or range is not possible. It may be helpful for ED 540 to acknowledge that in those circumstances, the auditor may not be able to obtain sufficient appropriate audit evidence.

c. Also, this could be confused as appearing to create an accounting requirement for auditors. Instead, we recommend ED 540 require the auditor to communicate situations in which management fails to properly address estimation uncertainty as a control deficiency and consider the effect on the audit instead of developing its own estimate as a substitute. We suggest linking this requirement, as well as other requirements (such as those that relate to understanding how management addressed management's bias in paragraph 10 of ED 540), to the requirements of the applicable financial reporting framework so that it is clear that it is management's responsibility to comply with the financial reporting framework and not the auditor's obligation to perform analysis in support of management's compliance with the financial reporting framework. We further recommend linking paragraph A125 of ED 540 to the circumstances in paragraphs 19(b) of ED 540.

   Additionally, there are many cases where the auditor will not be able to make an independent estimate and, in some audits, this may not be deemed the most effective approach. While the auditor can explore the consequences of changes in assumptions and measurement methods (and perhaps better understand the inherent measurement uncertainty from those sources), it is not clear how the auditor derived estimate or value provides more credible evidence in the typical situation.

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: No. Paragraph 33 of the Explanatory Memorandum explains that "the IAASB discussed concerns that this approach to "narrowing the range," coupled with a lack of explanation about what would constitute a "reasonable outcome," could result in an auditor's range that is inappropriately wide and agreed not to retain this approach. While we do not advocate overly prescriptive requirements or application material, we do not believe that the proposed requirement in paragraph 20 and the related application material in paragraphs A128–A134 of ED 540 will achieve the objectives and may not result in fewer "overly broad" ranges.

The range developed by the auditor needs to be sufficiently narrow to identify a material misstatement. Given the nature of certain accounting estimates, it may be impossible to narrow such a range to an amount below performance materiality (for example, actuarial reserves). Nevertheless, 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.

Paragraph A128 of ED 540 states that whether using an audit point estimate or developing an auditor's range, the auditor is performing substantive analytical procedures, and ISA 520, *Analytical Procedures*, addresses the use the auditor's use of substantive analytical procedures. We acknowledge that ISA 330 describes substantive audit procedures as tests of detail, substantive analytical procedures, or some combination thereof, and do agree that the requirements in ISA 520 are useful with regard to developing expectations and testing the reliability of data. However, we believe this paragraph in ED 540 will have unintended consequences for several reasons, including:

1. Paragraph A6 of ISA 520 states that substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

2. Paragraph A15 of ED 540 states that matters relevant to the auditor's evaluation of whether the expectation can be developed sufficiently precisely to identify a misstatement that, when aggregated with other misstatements, may cause the financial statements to be materially misstated, include the accuracy with which the expected results of substantive analytical procedures can be predicted. We note that often an auditor or an auditor's specialist may develop a range to evaluate the reasonableness of an amount or assumption to assist in providing evidence related to an estimate where the auditor is testing management's process. The development of the range in this circumstance is not intended to be sufficiently precise to identify a misstatement but, rather, is a data point in the auditor's overall conclusion.

3. Most significantly, paragraphA16 of ED 540 states that the determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other

misstatements, may cause the financial statements to be materially misstated. An unintended consequence is that paragraph A128 of ED 540 can be interpreted to suggest materiality is the expected limit when performing such substantive analytical procedures in testing accounting estimates. This is not operational for certain estimates.

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: Partially. We do not believe the revisions to ISA 500 will result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources for the following reasons:

1. The examples provided in paragraph A1C of ISA 500 to illustrate that an individual or external organization may be either an external information source or management's expert, but not both, are not sufficiently clear because they seemingly support an entity, in fact, being both. Is the IAASB intending to refer to a set of information as data or inputs, or assumptions? It may be more helpful to articulate the wording in terms used in extant ISA 500 or amend the examples.

2. With respect to these proposed conforming and consequential amendments in paragraphs A33A–A33H of ISA 500 intended to address the issue of external information sources, we have the following concerns:

    a. The proposed conforming and consequential amendments are focused on management's use of external information sources and management's evaluation and controls over such information rather than how the auditor considers its relevance and reliability as audit evidence. We believe that the concept of external information sources is equally relevant to the auditor's use of such information sources as audit evidence, but as drafted, this content is better placed in ED 540 to support testing management's process for the complexity of data.

    b. The proposed conforming and consequential amendments deal with one specific issue relative to audit evidence when we believe there are several issues arising from other IAASB projects that will be further explored in the Audit Evidence project. Examples include the use of data analytics, electronic audit evidence, and exhibiting professional skepticism. We are concerned that the narrow focus of these amendments may have unintended consequences when looked at in isolation and not in the overall context of the Audit Evidence project.

c. Paragraph A33G of ISA 500 does not consider the different sources of pricing information for financial instruments. As drafted, it does not sufficiently address the complexities of the financial market information available to management and auditors. We also recommend that the IAASB consider similar guidance to the PCAOB's proposal with respect to third party pricing information as that proposed standard recognized the differences in how estimates of price are determined and the differences in the extent of information necessary to determine relevance and reliability.

d. Paragraph A33H of ISA 500 addresses situations where management and the auditor use the same information source. The proposed conforming and consequential amendment is confusing because it could be interpreted that unless there is only one source, the auditor should not use the same source as management. However, we believe that the auditor may make use of the same information as management in situations where the risks of material misstatement is "low." Therefore, the proposed application material should be amended to reflect that the use of the same external information source as management is dependent on the risks of material misstatement.

We recognize that the use of external information sources is an important consideration, especially in auditing accounting estimates. Rather than proposing targeted conforming and consequential amendments to ISA 500, we recommend including certain aspects of the guidance (see above recommendations) in ED 540 as application material. This would include considering similar guidance within the PCAOB's proposal with respect to third party pricing information and testing management's data.

Other Comments

We read paragraph 24 of ED 540 as implying that some accounting estimates are free of bias. Paragraph 27 of ED 540 would then require audit documentation to evidence how each of these indicators was evaluated. In practice, it seems as though a conclusion that the accounting estimate was free of bias would be rather unusual and most circumstances are likely to be indicators of possible bias. Any judgment that involves selection from alternatives will introduce bias, but that bias is not necessarily inappropriate if supported by evidence. The use of the term "potential bias" may be overly broad and would suggest these requirements be based on the auditor's fraud risk assessment and indications of inappropriate, intentional bias. We believe that there needs to be some qualifier to evaluate inappropriate bias.

The communication required by paragraph 26 of ED 540 should be explicit that when management did not address estimation uncertainty (paragraph 19(b) of ED 540), it may constitute a control deficiency and the auditor may, therefore, have a communication requirement with those charged with governance. Identification of bias and effect on fraud risk should be specifically mentioned as points regarding how ISA 260, *Communication with Those Charged with Governance*, and ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, are applied.

With respect to Appendix 1, *Measurement Bases of Accounting Estimates*, we are unclear as to its intended purpose. We believe that the appendix to ED 540 appears to lean toward providing accounting application guidance and, therefore, are unclear how it corresponds to the requirements and application material in ED 540. We recommend that the IAASB consider deleting the appendix from ED 540. The content of the appendix may be considered as part of the development of an IAPN, if considered necessary.