Chairman

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Via e-mail

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

Dear Arnold

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the International Auditing and Assurance Standards Board's April 2017 Exposure Draft ("ED"), Proposed International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*. The Committee supports high-quality external audits of banks, which enhances the effectiveness of prudential supervision, thereby contributing to financial stability.

The Committee's main interest in updating ISA 540 was to address the auditing challenges surrounding the new accounting standards on Expected Credit Losses ("ECL") promulgated by the IAASB and the Financial Accounting Standards Board. It has been acknowledged that the "complexity, variability, and materiality of the ECL provision, and the need for judgment regarding certain key data and assumptions, are likely to give rise to one or more significant audit risks".[1] Thus, the IAASB set out to consider how ISA 540 could be further enhanced to drive appropriate audit procedures, taking into consideration the processes and controls in place at the entity, and reinforcing the application of professional judgment and professional skepticism for complex estimates, such as ECL.

Accordingly, at the outset of the project to revise ISA 540, the Committee requested that the IAASB focus the revisions on issues for audits of financial institutions arising from the adoption of ECL frameworks. However, the ISA 540 ED instead addresses all estimates and maintains that the audit requirements and guidance in the ED are relevant for all accounting estimates, as this term is defined in paragraph 9(a). We would have preferred that the IAASB adopt the approach we suggested because that approach would have enabled the audit challenges for the audit of ECL

[1] Please see www.iaasb.org/system/files/meetings/files/20160125-IAASB-Agenda_Item_1A-Draft_Project_Publication-final.pdf.

frameworks to be fully addressed in sufficient detail. However, bearing in mind the decision the IAASB has taken as to its focus, we agree that the ED will improve the requirements and guidance for the audit of complex accounting estimates (in general) for all types and sizes of entities and we support it on those terms.

We appreciate the significant efforts made by the IAASB and its ISA 540 Task Force to revise the standard to better support a high-quality audit of accounting estimates that are subject to complexity, judgment or estimation uncertainty. We further support the improvements made to the standard for enhanced risk assessments, the application of professional skepticism, and the requirement for the auditor to "stand back" and evaluate the audit evidence obtained. These improvements in the proposed standard address auditing challenges for estimates in increasingly complex business environments (such as approaches to models and data, obtaining an understanding of regulatory factors and additional internal control considerations) and go a long way towards enhancing ISA 540.

Additionally, we recommend that the ISA 540 Flow Chart be included within the standard. This tool provides a strong and straightforward explanation of how the standard should be applied and clearly shows that, if an accounting estimate has complexity, management judgment or estimation uncertainty, the auditor must adhere to the Requirements of ISA 540.

Furthermore, we strongly encourage the IAASB to finalise the standard expeditiously, with early adoption permitted, as it is important that auditors are able to apply the standard in the year that banks adopt an ECL accounting framework.

As the primary global standard setter for the prudential regulation of banks, our focus is on the application of ISA 540 (Revised) to complex estimates in banks, including the audit of ECL estimates. Thus, the Committee's views, set out below, are on key aspects of the ED that could be further enhanced to address the auditing of complex estimates in banks.

Identifying and assessing the risks of material misstatement and evaluating identified misstatements

We believe that the revisions to ISA 540 (Revised) will result in a more consistent determination of a misstatement than is done today. That said, the Committee recommends additions that we see as helpful to the identification and assessment of misstatements and the use of an auditor's range to evaluate management's point estimate, with reference to paragraphs 13–20 and 23, and the Application Material in paragraphs A67–A134 and A142–A146.

In the Committee's view, misstatements identified during the course of the audit of an accounting estimate should be communicated to, and corrected by, management as soon as possible (sufficiently in advance of the closure of the audit process). This will help minimise the impact that a misstatement, if uncorrected, would have on the fair presentation of the financial statements. Timely communication of misstatements is especially important within banks, where correcting misstatements may involve modifying highly complex models (or model inputs) and updating significant management judgments.

The Committee further recommends that the final standard cross reference to ISA 450, *Evaluation of Misstatements Identified during the Audit*, paragraph A3, which contains application guidance on distinguishing misstatements for the purpose of the auditor's evaluation, including misstatements arising from differences in facts, judgments and projections. In addition, the Application Material in ISA 540 paragraphs A142–A146 should be enhanced by referencing ISA 450 paragraphs 10–13, and providing guidance on how to evaluate the effect of uncorrected misstatements on the financial statements when judgments are involved. Currently guidance is included only when projections are involved and the auditor is expected to develop a range of possible outcomes as a basis of comparison with management's range or point estimate. Additional guidance is needed because, in our view, it will often not be possible for auditors to develop an independent range as a basis of comparison for complex estimates, such as ECL.

Lastly, the Committee views the Application Material in paragraphs A142–A146 as fundamental to the final standard, and recommends that the IAASB move this guidance to the level of Requirements.

Our additional recommendations pertain to identifying and assessing the risks of material misstatements, as they relate to complexity, judgment and estimation uncertainty (including assessing complex models, forward-looking information, management's point estimate within a range, and third-party models/data), and the scope of ISA 540). These recommendations are set out in Annex 1.

Internal control

For banks, a robust internal control environment is critical to the strength of an entity's governance system, its ability to manage risk, and the fair presentation of its financial statements, including the related disclosures. Paragraph 10 in the ED contains a general reference to the Requirements for the auditor to obtain an understanding of internal control, including the components of internal control as they relate to making accounting estimates. Paragraphs 16 and 26 provide guidance on testing the operating effectiveness of the internal control framework, and reporting internal control deficiencies to those charged with governance ("TCWG") when the auditor intends to rely on internal control, respectively. We recommend that the references to ISA 315 in footnote 25 to paragraph 10 of the ED be expanded to include references to paragraphs 5–13 of ISA 315 (Revised), in addition to the current references to ISA 315, paragraphs 5–6 and 11. This will allow auditors to more completely identify the extent of the ISA 315 Requirements relevant to ISA 540, paragraph 10, with respect to risk assessment procedures and obtaining an understanding of the entity and its environment, including its internal control.

The Committee believes that obtaining an understanding of internal control is critical for the audit of most estimates. Although we generally support the content of paragraphs 10, 16 and 26, we note the absence from paragraph 16 of an explicit reference to the design effectiveness of controls relating to accounting estimates. Accordingly, we urge that the standard be revised to clearly state the auditor's responsibility to evaluate the design and operating effectiveness of internal control, as required by paragraph 13 of ISA 315 (Revised), for processes that make extensive use of information technology and have a large number of estimates that are highly judgmental, complex or subject to high estimation uncertainty like those associated with the ECL estimate. For such estimates, we recommend that the standard state that the performance of substantive procedures alone will not be sufficient, except in limited circumstances. In our view, those limited circumstances will not exist within banks. Furthermore, examples of matters the auditor should consider when obtaining an understanding of the internal control framework are needed in the final standard to reinforce how auditors can meet these requirements, including emphasising that obtaining an understanding solely through management inquiry is insufficient.

Professional skepticism and management bias

Professional skepticism plays a central role in the audit of accounting estimates and the Committee notes that the ED contains several provisions to appropriately reinforce the auditor's application of professional skepticism and consideration of the potential for management bias. The Committee supports these provisions, and recommends that additional language be included in the final standard to further emphasise the importance of auditors exercising professional skepticism throughout the entire audit process. For example, the final standard should state that, in responding to the assessed risks of material misstatement for accounting estimates that involve complexity, management judgment or estimation uncertainty, such as ECL, auditors should challenge management's assumptions and question management's evidence on an ongoing basis during the normal course of the audit and appropriately document this process in the auditor's workpapers.

The Committee agrees that, when accounting estimates are subject to a high degree of management judgment, the estimate is inherently more susceptible to management bias, particularly when this judgment involves greater subjectivity, as stated in paragraph A85. This statement should be further strengthened by including concrete examples of *how* auditors could demonstrate the application of professional skepticism in these instances. This would be particularly useful for estimates that require management to form a view of the future, which is inherently complex and subject to significant judgment. We understand that these recommendations may be further considered by the IAASB, the International Ethics Standards Board for Accountants and the International Accounting Education Standards Board's Professional Skepticism Working Group, but we believe that professional skepticism is critically important and should be addressed in the final ISA 540.

Audit of Disclosures

We agree with the position set out in the Explanatory Memorandum to the ED that "disclosures relating to accounting estimates are critical to users' understanding of the accounting policies applied, the nature and extent of estimation uncertainty, key judgments and other matters relating to accounting estimates and more so when estimation uncertainty is high" (paragraph 44). We consider it essential that the auditor's evaluation of management's disclosures as required by ISA 540 be thorough enough to ensure that the disclosures help users to understand the nature and magnitude of the uncertainty affecting the estimates, the degree of complexity and the types of judgment made.

Please refer to Annex 1 for our detailed comments on the above topics and other aspects of the ED. We have also provided, in Annex 2, the set of principles by which the Committee has been guided in evaluating the ED. These principles are derived from the Committee's March 2014 Guidance on *External Audits of Banks*.[2]

We hope you find our comments constructive and helpful. This letter and its Annexes have been prepared by the Committee's Accounting Experts Group,

[2] Available at: www.bis.org/publ/bcbs280.pdf.

chaired by Fernando Vargas Bahamonde, Associate Director General of the Bank of Spain. If you have any questions regarding these comments, please contact Mr Vargas (+34 913 38 61 04), Nic van der Ende, chair of the Committee's Audit Subgroup (+31 20 524 91 11), or Ruby Garg at the Basel Committee Secretariat (+41 61 280 8463).

Yours sincerely

Stefan Ingves

Annex 1 – Comments on specific aspects of the ISA 540 ED

1. Identifying and assessing the risks of material misstatement and evaluating identified misstatements

The ED establishes requirements for identifying and assessing the risks of material misstatement in relation to accounting estimates and the auditor's responses to these risks in paragraphs 13–20. This is supplemented by Application Material in paragraphs A67–A134. The ED then addresses the evaluation of whether accounting estimates and related disclosures are misstated in paragraph 23, including the related Application Material in paragraphs A142–A146. The following sets out our detailed comments on these referenced paragraphs.

1.1 Auditor assessment of complexity, judgment and estimation uncertainty

Auditors should have established approaches and procedures to assess the risks of material misstatement of estimates when complexity, estimation uncertainty and significant judgments exist. The ED includes many relevant examples of complex estimates and examples of when accounting estimates are likely to have complex models in paragraph A81. Paragraph A1 includes examples of situations where accounting estimates may be required.

Many of these estimates are material to banks, such as ECL, fair value of financial instruments, and goodwill impairment. The complexity of these estimates is high because of the use of forward-looking information, complex models and externally developed models or data, amongst other factors. This increases estimation uncertainty, which consequently increases the risks of material misstatement for these estimates. Furthermore, changes to assumptions, models and data originating from management could add to estimation uncertainty. Given the inherent challenges these particular areas bring for management (in developing the estimate) and auditors (in gathering sufficient appropriate audit evidence), ISA 540 would benefit from additional guidance.

1.2 Auditor assessment when model complexity exists

With respect to an auditor's responsibility to address the risks of material misstatement related to complex methods (or models), paragraph 17 requires auditors to verify whether the calculations are mathematically accurate and appropriately applied. The guidance should be further expanded beyond mathematical accuracy to sufficiently address the risks of material misstatement due to model complexity. For example, the Application Material after paragraph A106 should be further expanded to indicate that the auditor's approach to the testing of models could vary depending on the assessed risk of material misstatement. The approach could range from a simple model review for accounting estimates with low inherent risk, to auditing the performance of the model or independently developing an estimate based on the auditors' own assumptions and/or model (when, in the auditor's judgment, it is necessary and possible) for estimates where inherent risk is not low. Nevertheless, we would emphasise that given the nature of complex internal models within banks, it could prove to be very difficult for an auditor to independently develop their own model for ECL estimates. In that situation, the auditor should put emphasis on assessing the appropriateness of internal processes, including assumptions, controls and the reasonableness of management's ranges and point estimates, as well as the model's theoretical soundness and mathematical integrity.

In addition, the Application Material should be expanded to include criteria for auditors in their consideration of the appropriate use of a particular approach. For example:

- A simple model review could be appropriate to address accounting estimates with an assessed risk of material misstatement that is low, based on low inherent risk. This could include a review of model documentation and methodology, management's governance processes and the internal control environment.

- Auditing the performance of the model may be appropriate to address accounting estimates for which the assessed risk of material misstatement is not low. This could include reviewing management's significant assumptions (considering the appropriateness of the data used and testing its integrity), reviewing the model's theoretical soundness and mathematical integrity, re-running the model to develop an expected outcome and back-testing procedures.

1.3 Auditor assessment of management's use of forward-looking information

The modelling of many accounting estimates requires management to consider forward-looking information and scenarios. Auditing forward-looking information is arguably one of the more challenging aspects of an audit and the ED provides little guidance in this area. We strongly recommend that additional audit guidance be developed for this complex area. We believe this would be helpful, not only for complex estimates in banks, but also for many of the estimates that are within the scope of ISA 540, including those identified in paragraph A1 of the ED. With reference to banks, this guidance would be relevant to the auditor's assessment of ECL accounting estimates, where there is high subjectivity, for example in management's choice of scenarios (which incorporate forward-looking information) and the related probability weights selected.

1.4 Auditor assessment of management's point estimate within a range

Where estimation uncertainty exists, management may develop a range within which an accounting estimate may reasonably fall. Paragraph A123 provides helpful guidance on matters auditors should consider in assessing the reasonableness of management's point estimate, which include evaluating (1) the appropriateness of management's selection between alternative methods and sources of data; (2) that management's assumptions are selected from a range of reasonably possible amounts; and (3) that management's point estimate is appropriately representative of the range of reasonably possible measurement outcomes.

We recommend that the standard be expanded to provide guidance on the auditor's responsibility for evaluating the point in the range chosen by management. Specifically, paragraph 19(b) (and its related Application Material) should be expanded to include an auditor's assessment of where management's point estimate falls within the range, whether there is a tendency to choose a point at either end of the range (eg the low end) and the determination of the appropriateness of management's choices within the accounting framework. While we understand that some financial reporting frameworks call for neutrality and do not specify whether any one point in the range is preferable to another, this additional guidance would be helpful for the auditor's evaluation of indicators of potential management bias in paragraph 22(a). As it relates to the auditor's overall evaluation of audit procedures performed that is required in paragraphs 22–23, which the Explanatory Memorandum refers to as the "stand-back" test, it would be particularly helpful to include the auditor's evaluation of the point in the range chosen by management, including the auditor's evaluation of whether there is a pattern of management selecting similar points within ranges for material estimates in the financial statements.

We also question whether the last sentence in paragraph A145 is the most appropriate: "when the audit evidence supports a range that does not encompass management's point estimate, the misstatement is the difference between management's point estimate and the nearest point of the auditor's range". If the auditor were to develop an independent estimate (which may not always be possible), we believe that the misstatement is more appropriately determined using the auditor's point estimate or best estimate within the range, and comparing this with management's point estimate.

As well, in relation to paragraph A114*,* we believe that, in cases where management has not reasonably considered alternative methods, sources of data and assumptions, auditors should be required to consider the need to obtain written representations from management on the reasonableness of its chosen methods, data sources and assumptions. Mere discussions with management (as stated in paragraph A114) by way of gathering audit evidence in our view would not be sufficient to address the risks of material misstatement. We view this suggestion to obtain written representation from management as consistent with the spirit of paragraph 25. However, paragraph 25 and paragraph A153 in the Application Material could be expanded as indicated below in our discussion on internal control.

1.5 Auditor assessment of third-party models or data

Data inputs are significant to many accounting estimates, making their relevance, accuracy and overall integrity critically important. For some estimates, banks, like other entities, may rely on externally sourced third-party models or data. With the inherent challenges of auditing externally sourced models or data and given the significant impact that models or data could have on an estimate's outcome, auditors should design and perform audit procedures responsive to risks around third-party systems and processes. In our view, auditors' responsibilities extend beyond in-house data and models to externally provided models or data. We support the consequential amendments that will be made to ISA 500, *Audit Evidence,* in paragraphs A33A-A33H. We believe that ISA 540 should include a stronger reference to the relevant paragraphs in ISA 500, because the link between ISA 540 (Revised) and the current guidance in ISA 500 could otherwise be missed. A few examples could include:

- When external data sources are used, auditors should assess whether data and assumptions obtained from the external sources are reliable, relevant, complete and accurate.
- When a third-party model is used, auditors should assess the model methodology (including theoretical soundness and mathematical integrity), the appropriateness of model inputs (eg data and assumptions), and validation procedures and controls over the model.

1.6 Scope and assessment of risk

We support the inclusion in paragraph A73 of examples where "the risks of material misstatement may be influenced by inherent risk that is not low", and in particular that this should be the case for "accounting estimates…..such as an expected credit loss model in a financial institution that is active in different markets". Paragraph A81 also recognises that ECL estimates are likely to be based on complex models. We note that the application of the ECL approach involves (i) a high level of complexity; (ii) the exercise of significant judgment; and (iii) high estimation uncertainty. For these reasons, we agree that the ECL assessments by banks should normally remain within the scope of ISA 540, notably because the inherent risk cannot normally be assessed as low for a bank. We make the following additional recommendations to ensure that the standard adequately emphasises the complexity of auditing ECL estimates:

(a) Amend paragraph 13 to include the element of paragraph A73 mentioned above, except that the reference to banks using an ECL approach should not be limited to those banks active in different markets, and rather should extend to all banks. In addition, we strongly believe that the inherent risks related to ECL for banks should systematically be considered not low as a rebuttable presumption.

(b) Include the contents of paragraph A78 within the Requirements of paragraph 13, to require auditors to consider the factors listed in paragraph A78 when assessing the risks of material misstatement. We strongly believe that the regulatory environment, including relevant regulatory requirements, should be systematically considered as part of the assessment of the risks of material misstatement. In addition, we recommend that paragraph 13 include requirements regarding appropriate documentation in relation to the identification and assessment of the risks of material misstatement, especially when inherent risk is assessed as low.

2. Internal control

A robust internal control environment is critical to the strength of an entity's governance system and its ability to manage risk, including the risk of materially misstated accounting estimates. We support the ED Application Material, in paragraphs A48–A60, for auditors to obtain an understanding of internal control over estimates for entities of all sizes, which largely clarifies the interplay between ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*; ISA 330, *The Auditor's Responses to Assessed Risks*; and ISA 540 (Revised). Our further suggestions include specific guidance on audit considerations and procedures for obtaining an understanding of internal control over estimates and aim to strengthen the link between ISA 315, ISA 330 and ISA 540.

We agree with the text in paragraphs A30, A42, A43 and A49 that an entity's system of internal control should be commensurate with the nature, volume and complexity of its activities. A high-quality audit requires an auditor to first assess the risks of material misstatement of the estimate, taking into account the effectiveness of the entity's internal control framework (both design and operating effectiveness of internal control), and then to design audit procedures responsive to the assessed risk. We strongly agree that substantive procedures alone are often not sufficient for certain types of estimates, including estimates of ECL, and are rarely sufficient for banks.

2.1 Obtaining an understanding of internal control over estimates

We support the inclusion of paragraph 10(f) in the ED and the related Application Material in paragraphs A48–A60, which require auditors to obtain an understanding of internal control components as part of the risk assessment. ISA 315 contains a number of examples of matters that auditors should consider when obtaining an understanding of an entity's internal control environment. In addition, we recommend including in ISA 540 the following examples of matters to consider when obtaining an understanding of an entity's internal control environment with regard to accounting estimates:

(i) *Knowledge of the entity's internal control* ***over estimates*** *obtained by the auditor during prior audits and other engagements performed by the auditor, as well as engagements performed by internal audit;*

(ii) *Control deficiencies* ***relevant to accounting estimates*** *previously communicated to those charged with governance or management;*

(iii) *Preliminary judgments about the effectiveness of internal control over financial reporting* ***relevant to estimates****; and*

(iv) *The size and relative complexity of the entity's operations in general and the* ***complexity of estimates*** *in particular. Complexity will likely affect the risks of material misstatement and the controls necessary to address those risks.*

We propose the introduction of additional words (underlined below) to paragraph 15 to establish that an understanding of internal control is important for most audits and that the auditor needs to test controls when substantive procedures alone are not sufficient:

- *15(a) - When inherent risk is low, <u>as determined through the auditor's risk assessment procedures</u>, 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 in the circumstances.*

- *15(b) When inherent risk is not low, <u>for example, as is the case with accounting estimates that make use of complex models or are highly judgmental,</u> the auditor's further audit procedures shall include procedures to obtain audit evidence about the matters in paragraphs 17–20, when applicable. (Ref: Para A97)*
- *Include at the end of paragraph 15 (before paragraph 16), "<u>The results of the work that the auditor performs as part of their risk assessment procedures, which includes developing an understanding of relevant internal controls, shall inform the approach taken by the auditor to audit the estimate.</u>"*

Within the Application Materials, we recommend changes to describe the audit procedures necessary to obtain an understanding of the internal control over estimates, including for audits of smaller entities. In particular, in paragraph A10, we recommend adding that, in audits of smaller entities, the auditor may obtain an understanding of internal control over accounting estimates by performing walkthroughs. In our view, inquiry alone is not sufficient to obtain an appropriate understanding of internal control over accounting estimates.

We are supportive of Application Material paragraph A30, which provides guidance on the factors auditors should consider as part of obtaining an understanding of models. In particular, we agree that additional controls around models are more likely to be relevant to the audit when the model used is complex, such as for ECL models.

We recommend that the final standard include the following underlined edits in paragraph A49 to emphasise and clarify the need for the auditor to understand internal control when auditing most entities, and that obtaining an understanding of internal control is not limited to audits of entities with a wide range of estimates.

A49. <u>It is important for the auditor to understand the design and implementation of relevant controls to address the risks of material misstatement.</u> <u>This is true for most estimates, but its importance increases as the complexity of an estimate and the risks of material misstatement increase.</u> Some entities may have a wide range of accounting estimates, some of which may be significantly affected by, or subject to, complexity, the need for <u>the</u> use of judgment by management, and estimation uncertainty. In such circumstances, there may be an increased need for the application of specialized skills or knowledge, and management may make extensive use of information technology in making the estimates. <u>For such estimates, it is even more important</u> for the auditor to understand the design and implementation of relevant controls, and also to test their design and operating effectiveness in addressing the assessed risks of material misstatements.

We suggest adding a new factor and propose adding the two sentences below to paragraph A58 to emphasise the importance of understanding the precision applied by management in executing controls and whether controls are designed at a sufficiently precise level to prevent or detect a material misstatement on a timely basis:

> *The auditor may consider the level of precision applied by management in executing these control activities. Controls should be designed to operate at a level of precision that would prevent or detect misstatements of one or more assertions regarding estimates.*

In addition we suggest that the following be added to paragraph A50:

To understand the likely sources of potential misstatements and, as a part of selecting controls to test, the auditor may achieve the following objectives:

(i) Understand the flow of transactions related to the relevant assertions;

(ii) *Identify the points within the entity's processes at which a misstatement, including a misstatement due to fraud, could arise;*

(iii) *Identify the controls that management has implemented to address these potential misstatements; and*

(iv) *Understand how information technology affects the flow of transactions.*

2.2 Testing the design and operating effectiveness of internal control over accounting estimates

We support the inclusion of paragraph 16 and the related Application Material in paragraphs A98–A100. However, these paragraphs (including paragraph 8 of ISA 330, which is referenced in the footnote to paragraph 16 of ISA 540) require auditors to test only the operating effectiveness of internal control relating to accounting estimates if auditors intend to rely on controls relating to accounting estimates or if substantive procedures alone cannot provide sufficient appropriate audit evidence. Given the complexity of many accounting estimates and the necessity of implementing appropriate controls from a risk management perspective, it is imperative that the auditor also evaluate the design of controls relating to estimates. Therefore, we urge the IAASB to enhance paragraph 16 by adding the following underlined language to the final standard, which in particular clarifies our expectations for audits of banks. In addition, the audit response should include consideration of control deficiencies identified and an assessment of the impact of such deficiencies on the audit.

16. If the auditor intends to rely on controls relating to accounting estimates, or if substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level, <u>as in the case of audits of entities (such as banks) that make extensive use of information technology and have a large number of estimates that are highly judgmental, complex, or subject to high estimation uncertainty,</u> the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to their operating effectiveness. <u>The auditor shall test and evaluate the design and operating effectiveness of internal controls related to accounting estimates based on the assessed risk and perform such other procedures as the auditor considers necessary in the circumstances. In addition, the auditor shall evaluate the impact of any deficiencies in internal control on the assessed risk.</u> (Ref: para A98–A100)

We support the inclusion of paragraph 25 requiring the auditor to obtain written representations from management stating that they believe the methods, significant data and assumptions used in making the accounting estimates and their related disclosures are appropriate to achieve recognition, measurement and disclosures that are reasonable in the context of the applicable financial reporting framework. We believe the auditor should also obtain written representations from management acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting and suggest that this requirement be incorporated in the standard.

We support the inclusion of paragraph A98, which explains circumstances where it is not possible or practicable for auditors to perform only substantive procedures, such as for banks that make extensive use of information technology and have a large number of estimates that are highly judgmental or complex. We agree that substantive procedures alone may not provide sufficient audit evidence. This will be the case where there is a large volume of transactions, significant information is produced electronically, complex models are used or information is used across systems, which is the case for ECL estimates that integrate the entity's risk management and financial reporting systems. This situation will also arise for reasons that are not principally driven by information technology, such as the nature of the accounting methods being applied. It would be further helpful if paragraph A98 began by providing guidance on those aspects that drive the decision to rely on controls, followed by examples of the limited circumstances that may support relying only on substantive procedures to provide sufficient appropriate audit evidence.

2.3 Auditor's responsibility to report significant deficiencies in internal control

We support the inclusion of paragraph 26 which clarifies the application of ISA 260 (Revised), *Communication with Those Charged with Governance* and ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*, with respect to the requirement that auditors report to TCWG on significant deficiencies in internal control, among other matters. Given the nature of accounting estimates and the impact of control deficiencies on estimation uncertainty, we recommend addressing the timing of communicating with management and TCWG. This is especially important for banks that rely heavily on information technology and have complex internal processes. In these cases, early identification and communication of internal control deficiencies provides an opportunity for a bank's management to take steps to remediate the control deficiencies and correct any resulting misstatements on a timely basis.

3. Professional skepticism and management bias

The application of management judgment is pervasive in the measurement of complex accounting estimates, including, but not limited to, ECL. Significant management judgments may exist, for example, in the selection of key accounting policies, development of methodologies and data sources, and the choice of assumptions. We strongly support the efforts of the IAASB to address this issue. In particular, we support the references to unintentional or intentional bias in paragraphs 18(a)(i)b) and A7, and the requirement that the potential for management bias should be taken into account in paragraph 13(b) with respect to methods, assumptions and data.

As judgment can have a material impact on the outcome of the reported estimate, it is critical that ISA 540 emphasises that auditors must demonstrate how they exercised professional skepticism to critically evaluate management's judgments, throughout all stages of the audit, as well as at the end of the audit.

3.1 Demonstrating professional skepticism throughout all stages of the audit

The ED addresses professional skepticism as a key concept in paragraph 5. This paragraph emphasises the importance of the application of professional skepticism, particularly in relation to the risk of management bias affecting the outcome of estimates that are subjective, complex and uncertain. We agree that the application of professional skepticism plays a central role in the audit of estimates and thus, that this concept is appropriately located at the start of the standard. Paragraph 5 should be reinforced by adding a statement in the final standard that *the auditor shall exercise professional skepticism throughout all stages of the audit and prepare appropriate audit documentation to demonstrate the application of professional skepticism.*

With respect to the overall evaluation based on audit procedures performed that is required in paragraphs 22-23, we recommend that the "stand-back" test also require the auditor to perform an overall assessment of whether a sufficient level of professional skepticism has been applied by the auditor. This is particularly relevant to areas when the determination of an accounting estimate requires significant management judgment and is therefore more susceptible to management bias.

3.2 Professional skepticism and management judgment

The ED recognises the importance of professional skepticism, pointing in particular to the link to "estimation uncertainty" in the Application Material in paragraph A93. The final standard should strengthen the link between the existence of significant management judgments and the importance of auditors demonstrating professional skepticism. Paragraph A85 states: "[w]hen accounting estimates are subject to a high degree of judgment, the accounting estimate may be more susceptible to the potential for management bias, particularly when this judgment involves greater subjectivity...". We agree with this statement and believe that paragraphs 18 and A85 should be expanded to incorporate the need for the auditor to demonstrate the application of professional skepticism in these cases. This could be achieved by adding the following underlined language to paragraph A93: *when the reasons for the assessment given to the risks of material misstatement include estimation uncertainty and management judgment, the auditor's application of professional skepticism is particularly important.* We further recommend incorporating paragraph A93 into the standard's Requirements in paragraph 18.

In addition, paragraph A85 speaks to the potential for management bias when new estimates make it necessary to revise judgments previously made by management for other estimates. We suggest that the latter be emphasised because there is a high risk of management bias when a new estimate indicates that a previous management judgment needs revision.

Lastly, an increased focus on skepticism could be achieved by adding the following to the end of paragraph A69: "applying specialized skills or knowledge as well as demonstrating a questioning mind-set and sound professional judgment".

3.3 Application of professional skepticism to areas of management judgment

Where the risks of material misstatement are high and require more persuasive audit evidence (paragraph 15b), the final standard should explicitly require auditors to use professional skepticism by "challenging" management's assumptions, where appropriate. This could be reinforced by including examples in the corresponding Application Material (paragraph A97) on how auditors could form their own independent views on certain data or management assumptions and on how auditors could challenge management's assumptions. As an example, auditors could do so by looking at sources of data other than those chosen by management, such as macroeconomic data relevant for forward-looking information, as a way of demonstrating a questioning mind-set and gathering more persuasive audit evidence. Auditors should also seek to obtain and consider any contradictory audit evidence during the course of the audit as part of the overall "stand-back" test included in the ED in paragraphs 22–23.

3.4 Work of the Professional Skepticism Working Group

We understand that the Professional Skepticism Working Group was established jointly by the IAASB, the IESBA and the IAESB in June 2015 to provide input into the development of ISAs under revision, including the ISA 540 ED. We strongly encourage that this work continue as a priority and view it as an opportune time for the PSWG to now develop recommendations on how to more effectively respond to issues related to professional skepticism, including the interaction between professional skepticism and the audit of complex estimates. Nevertheless, to support the timely issuance of ISA 540, we recommend that the specific requirements on professional skepticism that we have recommended above be included in the final version of ISA 540. If the PSWG identifies further enhancements on professional skepticism, these may be added later to the appropriate ISAs.

4. Audit of Disclosures

We consider it essential that the auditor's evaluation of management's disclosures, as required by ISA 540, be thorough enough to ensure that the disclosures help users to understand the nature and magnitude of the uncertainty affecting the estimates, the degree of complexity and the types of judgments made. Therefore, we support the alignment of the audit objective for disclosures with the objective for the other aspects of the audit of the related accounting estimate, so that "reasonable" is the benchmark (paragraph 8 of the ED).

We are concerned that references to audit considerations on disclosure are dispersed throughout the ISA 540 Requirements and Application Material. For example, guidance on disclosure is addressed in paragraphs (including, but not limited to) A2, A16, A57, A88, A123–125, A136, A137 and A153. This reduces the cohesiveness and understandability of this guidance and could undermine the importance attached to the auditor's responsibilities for disclosures. As such, we recommend that the IAASB bring this guidance together in one place. If this is not possible, we recommend increasing the cross references between the paragraphs noted above.

Because of the high degree of judgment involved in making ECL estimates, clear disclosure around where in the range a point estimate is, why the point estimate is appropriate, and what the point estimate is sensitive to, are especially important in assessing the reasonableness of an estimate. We therefore support the change outlined in paragraphs 43–45 of the Explanatory Memorandum to the ED that expands the requirement for auditors to consider disclosures that describe estimation uncertainty when it relates to risks other than just those regarded as significant (paragraph 19a(ii)). We also support the inclusion of paragraph A134 and agree that the auditor's evaluation of the reasonableness of disclosures becomes increasingly important as estimation uncertainty increases.

We further recommend paragraph A2, which includes important expectations on disclosures, be included in the standard's Requirements, along with the material in paragraphs A123–A125.

Annex 2 –The Committee's principles for a high-quality audit of ECL

The following principles are derived from the Committee's March 2014 Guidance on *External audits of banks*.

Loan loss provisioning is generally material for a bank's financial statements and the calculation of capital and key performance metrics. The measurement of loan loss provisions involves complex judgments which are subjective in nature.

1. External audits of financial statements performed in accordance with the relevant auditing standards should enhance the confidence of all users, including supervisors, in the reliability of the audited financial statements and the quality of the information provided.
2. Commensurate with the size, complexity and diversity of banking activities, and the legal and regulatory framework in which banks operate, the external auditor of a bank should have specialised knowledge and competence in auditing banks. Knowledge and competence are particularly important in an external auditor's ability to exercise professional judgment and carry out key aspects of the audit, such as identifying and assessing the risks of material misstatement and designing and implementing appropriate responses to those risks.
3. The external auditor should exercise professional skepticism when planning and performing the audit of a bank, having due regard to the specific challenges in auditing a bank. Professional skepticism should manifest itself not only through the auditor obtaining corroborating evidence for management's assertions, but also challenging management's assertions, considering whether there are alternative accounting treatments that are preferable to those selected by management, and documenting the auditing approach, the evidence obtained, the rationale applied and the conclusions reached. Throughout the audit, the auditor "adopts a questioning approach when considering information and in forming conclusions". [3]
4. External auditors should be satisfied that the bank's system of internal control is commensurate with the nature, volume and complexity of the bank's activities and is organised in accordance with regulatory and legal requirements. The internal control structure of a bank must be robust and reliable in order to cope with stressed environments.
5. ISAs require the external auditor to obtain an understanding of control activities relevant to the audit (those activities necessary to assess the risks of material misstatement and to establish the audit strategy). The external auditor of a bank should identify and assess the risks of material misstatement in the bank's financial statements, taking into consideration the complexities of the bank's activities and the effectiveness of its internal control environment.
6. The external auditor of a bank should respond appropriately to the significant risks of material misstatement in the bank's financial statements.

[3] IAASB (February 2012), Staff Questions & Answers – Professional Skepticism in an Audit of Financial Statements, Question 1.