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COMPAGNIE NATIONALE DES COMMISSAIRES AUX COMPTES

ORDRE DES EXPERTS-COMPTABLES
Conseil Supérieur

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To the attention of Mr. Matthew Waldron
IAASB Technical Director

0753

Paris, 19 July 2017

Ref: JBO.BNB.CBO.20170444

Subject : Comments of IAASB's Exposure Draft (ED) – Proposed International Standard on Auditing 540 (Revised) – Auditing Accounting Estimates and Related Disclosures

Dear Sir,

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) are pleased to provide you with their comments on the proposed International Standard on Auditing 540 (Revised) – Auditing Accounting Estimates and Related Disclosures.

We support the IAASB's decision to explore this topic. The revision of ISA 540 is crucial to ensure the standards to fit for purpose in light of today's evolving and complex business environment.

We acknowledge that ISA 540 is an important standard. We recognize the IAASB's effort to provide sufficient guidance on the diverse estimates to which ISA 540 should apply, ranging from simple accounting estimates to very complex ones. Accounting estimates are one of the major issues identified globally in regulatory audit inspections, with comments specifically around the lack of auditor challenge and apparent shortcomings in the application of professional skepticism.

We recognize the IAASB's attempt to address scalability in ED-540. Nonetheless, we are concerned that the scalability that was desired has not actually been achieved at a satisfactory level due to:

– the overall complexity and length of the standard, and
– the lack of clarity on the extent of the required understanding of internal control for low risk estimates (see answer to question 3).

We would also like to draw your attention on the fact that in order to deal with the practical issue arising from the first time application of IFRS 9, the CNCC has felt the need to develop a professional guidance in French and English addressing the statutory audit procedures relating to loan provisioning under IFRS 9 for credit institutions. This guidance "a guide to statutory audit procedures on expected credit loss provisioning under IFRS 9 in credit institutions" is attached to the present letter and is available at the following web address: https://doc.cncc.fr/docs/note-relative-aux-diligences-v2/attachments/english-version-note-diligences-provisionnement-credit-ifrs-9-january-2017.

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Responses to the specific questions raised in the Consultation Paper are set out below.

If you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours faithfully,

Jean Bouquot
President of CNCC

Charles-René Tandé
President of CSOEC

Comments

Overall Questions:

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

We appreciate the efforts done to revise ISA 540 to deal with evolving financial frameworks relating to accounting estimates, especially IFRS 9 - International Financial Reporting Standard (IFRS) 9 - *Financial Instruments*. For example, ED-540 highlights that the auditor's identification and assessment of the risks of material misstatement for accounting estimates, and the auditor's responses to those assessed risks, are affected by complexity, the need for the use of judgment by management and estimation uncertainty. Accordingly, these three factors are incorporated throughout ED-540. ED-540 also emphasizes the important considerations regarding complex models, forward-looking information, and internal controls in auditing accounting estimates.

Insurance contracts

However, we have the feeling that ED 540 is currently focused on financial institutions and should also include some insurance companies' considerations.

We therefore suggest the following amendments to take into account the specificities introduced by the newly published IFRS 17 - *Insurance contracts*, while remaining framework neutral. These amendments are listed below:

- Paragraph A5 could mention the fulfilment cash flows of insurance contracts as an example of an accounting estimate as a whole;
- Paragraph A73 could make a reference to insurance contracts liabilities as an example of
  - Accounting estimates for which a complex model is used with entity's specific assumptions (third bullet point)
  - Accounting estimates that collate, weight and integrate assumptions and data from a wide range of sources (fourth bullet point);
- In paragraph A74, an example regarding insurance liabilities could be added to illustrate complex modelling under IFRS 17 (IFRS 17 basis for conclusion includes wording illustrating the complexity of the accounting model that could be re-used);
- Paragraph A84 could make a reference to contractual cash flows of a group of insurance contracts as an example of accounting estimates that are likely to be subject to a high degree of judgment in amount, timing and uncertainty (first bullet point);
- Paragraph 18 of Appendix 1 could refer to insurance contracts liabilities estimation as an illustration of situations where expert or entity specific values are used rather than historical transactions;
- In paragraph 24 which typically deals with situations met in insurance, a reference to insurance contracts could usefully be added.

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

Professional skepticism plays a central role in the audit of accounting estimates. ED-540 contains several key provisions that are designed to enhance the auditor's application of professional skepticism and consideration of the potential for management bias, including enhanced risk assessment requirements, more granular requirements with respect to obtaining audit evidence (when inherent risk is not low), and requirements to "stand back" and evaluate the audit evidence obtained regarding the accounting estimate, including both corroborative and contradictory audit evidence.

We welcome the initiative taken by the IAASB to drive actions that promote professional skepticism. We consider that this is a step forward. However, we believe that professional skepticism is not stemmed from a checklist. As mentioned in ISA 200[1], professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud and a critical assessment of audit evidence.

[1] ISA 200 - *Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing*

We therefore consider that the requirements and application material of ED-540 appropriately and adequately reinforce the application of professional skepticism when auditing accounting estimates.

Focus on Risk Assessment and Responses:

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

We recognise the IAASB's willingness to properly address scalability in ED-540.

The IAASB sought to make ED-540 scalable, recognizing that the standard applies to all accounting estimates. The ED-540 requires the auditor, when dealing with accounting estimates with low inherent risk, to determine whether one or more specific further audit procedures that may provide sufficient appropriate audit evidence in the circumstances. For inherent risk that is not low, the auditor is required to design further audit procedures to obtain audit evidence about matters relating to complexity, judgment or estimation uncertainty, to the extent these factors are the reasons for the assessed risks of material misstatement.

Including such criteria helps distinguishing the work effort requirements for simple and non-risky accounting estimates from others that have been evaluated as having an inherent risk other than low.

However, we consider that the scalability that was desired has not actually been achieved at a satisfactory level for the following reasons:

- The overall complexity and length of the standard;
- The lack of application material for accounting estimates with low inherent risk;
- The lack of clarity on the extent of the required understanding of internal control for low risk estimates.

Overall complexity and length of the standard

The standard is long and complex.

A diagram (illustration of work effort requirements), such as the one distributed with the ED, should be included as an appendix to the standard to help understanding the rationale and structure of the standard.

Lack of application material for accounting estimates with low inherent risk

Moreover, we note an important difference in weight in the application material between the sections dealing with low inherent risk and not low inherent risk. There are limited examples provided in the application material in paragraph A72, where auditor's assessment of the risk of material misstatement may be based on low inherent risk. Even in those examples, we can see, depending on the facts and circumstances that an accounting estimate might result in being an inherent risk that is not low. For instance, regarding "bonus accrual for management", we would argue that there will be an increase in management bias where the profitability of the entity may affect the accounting estimate (i.e. their bonus) which will lead to the conclusion that the inherent risk is not low. To avoid any possible misinterpretation of these examples, we suggest including a sentence in paragraph A71 to reflect how important it is for the auditor to consider the specific facts and circumstances before concluding if an inherent risk is low or not low.

The lack of clarity on the extent of the required understanding of internal control for low risk estimates

In addition, we believe that there is lack of clarity on the extent of the required understanding of internal control for low risk estimates.

As defined in ISA 200, inherent risk is assessed before consideration of any related controls. The logic of this ED is to set the assessment of risks on the estimates at the level of inherent risk. The auditor should therefore be allowed not to obtain an understanding of internal control for all estimates where he assesses the inherent risk as low. On the contrary, paragraph 10 (f) states that the auditor is required to obtain an understanding of **each of the component** of internal controls **as they relate** to making accounting estimates thereby giving the impression that a detailed assessment of internal control is required for all the 5 components of internal control specifically for accounting estimates.

In addition, paragraph 16 placed at the end of the main work effort section gives the impression that the auditor has to test the controls as part of his response to the risk even if the auditor was able to apply paragraph 15 (a).

As a matter of fact, in our opinion, ISA 315 by requiring that the auditor obtains an understanding of internal control **relevant to the audit** should allow the auditor not to obtain an understanding of internal control relating to low inherent risk accounting estimates, since this understanding will in fact not be relevant to the audit.

A proper treatment of this issue would certainly help the scalability of the approach.

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

a) Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?

Please refer to our comments relating to question 3.

b) Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?

Yes, we support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity in making the accounting estimate, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty, although, we believe that the distinction between those three factors is a bit artificial and the auditor will not be able to connect a specific work effort to each factor.

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

We consider the definition of the term "significant data", which is mentioned several times in paragraphs 17-18, to be important in the understanding of the respective requirements. We would therefore suggest moving the explanation included in paragraph A35[2] to the "Definitions" sections in page 31 of ED-540 or otherwise have it properly signposted.

[2] Paragraph A35 of the proposed ISA: *"Data and assumptions used in making an accounting estimate are referred to as significant data or significant assumptions in this ISA if a reasonable variation in the data or assumption would materially affect the measurement of the accounting estimate. For example, an accounting estimate may be determined applying a method that uses several data sets and several assumptions, one or more of which particularly influences the measurement of the accounting estimate because the range of reasonable assumptions may be large or the model may be sensitive to specific data or assumption because of the underlying formulas."*

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?

Yes, we believe that the requirement in paragraph 20 appropriately establishes how the auditor's range should be developed.

We are supportive of requiring the auditor, to the extent possible, to develop an auditor's point estimate or range to enable him to evaluate the reasonableness of management's point estimate and the related disclosures that describe the estimation uncertainty.

We also support the idea that all the point estimates in the management range are acceptable. Thereby, we agree that in cases where the auditor's point estimates is outside the management range, the misstatement is the difference between the auditor's point estimate and the closest point of the management range and not more.

We also support the idea that the concept of reasonable range (i.e. a range that contains only reasonable estimates) and materiality are not linked. Thereby, we recommend to move the first sentence of paragraph A134 to the requirements section, i.e. "*In certain circumstances, the auditor's range for an accounting estimate may be multiples of materiality for the financial statements as a whole, particularly when materiality is based on operating results (for example, pre-tax income) and this measure is relatively small in relation to assets or other balance sheet measures*".

6) Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor's range to evaluate management's point estimate?

Paragraph 23 requires the auditors to evaluate "whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated". Whereas we agree with using the term "reasonable" when referring to accounting estimates, we consider that in relation to disclosures, the term "reasonable" should be changed for "appropriate", since the element of judgment is important with regard to accounting estimates and related disclosures.

Conforming and Consequential Amendments:

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?

We agree with the proposed conforming and consequential amendments to ISA 500 regarding external information sources. The revision to the requirement in paragraph 7 and the related new additional application material will result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources. It is important to think about information sources that are outside the organisation, considering the increased use of data analytics.

However, since the ISA 500 should be revised in two years, we consider that "there is no need to take urgent action". We believe that these amendments should be treated in a staff alert. The professionals need a stable platform.

Request for General Comments:

8) In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

(a) Translations—Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-540.

As mentioned here above, we have a concern with the term "reasonable". We recommend the IAASB changing the term "reasonable" to "appropriate when referring to disclosures.

(b) Effective Date—Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

We agree that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. We regret that ISA 540 will not be published ahead of IFRS 9 – *Financial Instruments* which was the initial intention of the IAASB.

We understand that this standard is tackling several critical issues and therefore requires time to be developed. Having a well-developed standard will enhance the confidence of those using the standard and will help maintain audit quality. We are also supportive of permitting and encouraging an earlier application.

The CNCC has already issued a professional guidance in French and English to address the statutory audit procedures relating to loan provisioning under IFRS 9[3] for credit institutions. This guidance[4] is attached to the present letter and is available at the following web address: https://doc.cncc.fr/docs/note-relative-aux-diligences-v2/attachments/english-version-note-diligences-provisionnement-credit-ifrs-9-january-2017

[3] IFRS 9 – *Financial Instruments*, published on 24 July 2014, combines in a single standard three phases of the project to replace IAS 39: classification and measurement, impairment, and hedge accounting. This standard was endorsed by the European Union upon adoption of Commission Regulation (EU) No. 2016/2067 published in the Official Journal of the European Union on 29 November 2016. The standard's mandatory effective is 1 January 2018.
[4] A guide to statutory audit procedures on expected credit loss provisioning under IFRS 9 in credit institutions