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529 Fifth Avenue, 6th Floor
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Exposure Draft, *Proposed International Standard on Auditing 540 (Revised), Auditing Accounting Estimates and Related Disclosures*

Dear Mr. Waldron

Ernst & Young Global Limited, the central coordinating entity of the EY organization, welcomes the opportunity to offer its views on the Exposure Draft, *Proposed International Standard on Auditing 540 (Revised), Auditing Accounting Estimates and Related Disclosures* (ED-540), issued by the International Auditing and Assurance Standards Board (IAASB).

As financial reporting standards continue to increase in their complexity, management's processes to prepare accounting estimates also increase in complexity. Consequently, we believe it is appropriate for the IAASB to consider how International Standard on Auditing (ISA) 540¹ can be enhanced to reflect the evolving nature of financial reporting standards that address accounting estimates, as well as the auditing challenges that arise therefrom. We support the IAASB's initiative to prioritize the enhancements to ISA 540 to be responsive to, in particular, the impending effective date of IFRS 9², which presents heightened challenges to both management and auditors as it relates to the preparation and auditing, respectively, of estimates related to expected credit losses. Nevertheless, some of the same auditing challenges identified in respect of IFRS 9 exist in practice today for other complex accounting estimates, to varying degrees, including across industries. Therefore, we support the IAASB's approach to enhance ISA 540 for the audit of all accounting estimates, not just those related to IFRS 9 or the audit of financial institutions.

Overall, we believe the IAASB has identified and understood the relevant issues in practice related to auditing accounting estimates in the current environment. We have focused our analysis of ED-540 on its capability of being implemented appropriately and consistently in practice. Our comments are informed by our practical experiences, including enhancements we have made in recent years to our EY Global Audit Methodology related to auditing estimates, and the input from our auditors, including those experienced in the audits of financial institutions.

Our significant views and areas of concern related to ED-540 are summarized as follows:

- We believe several enhancements have been made to reflect the evolving nature of financial reporting standards, but we have further suggestions. In particular, we believe that the auditor's risk assessment procedures and the resulting design of responsive audit procedures need to specifically take into account whether management's process to make the accounting

¹ ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*

² International Financial Reporting Standard (IFRS) 9, *Financial Instruments*

estimate represents the appropriate application of the requirements of the applicable financial reporting framework (see our response to Q1).

- We support the risk-based differentiation of accounting estimates between those for which inherent risk is “low” and “not low”. However, we believe that the testing approaches that have been identified as only being applicable to estimates with “low” inherent risk are also applicable to estimates with “not low” inherent risk, and this applicability needs to be clarified in ED-540. In our view, the objective-based requirements in paragraphs 17-19 (a) that address procedures for estimates with “not low” inherent risk equate to an audit approach to test how management made the accounting estimate (see our response to Q4 (c)).
- We agree that complexity, management’s use of judgment and estimation uncertainty are relevant drivers of risks related to accounting estimates, and we support the specific consideration of these factors in the auditor’s risk assessment as well as in the design of responsive audit procedures. However, we believe that the approach to the related work effort (i.e., requiring each of these factors to be addressed separately) in paragraphs 15 and 17-19 is unnecessarily complicated and does not reflect the approach that is taken, or should be taken, in practice to designing and developing audit procedures for accounting estimates (see our responses to Q3 and Q4).
- With regard to the enhancements to the auditor’s work effort for disclosures related to accounting estimates, we have the following specific concerns:
 - We are concerned about changing the criterion for the auditor’s evaluation of disclosures related to accounting estimates to “reasonable” from “adequate”. The rationale for the change included in the explanatory memorandum is not consistent with our understanding of the rationale for the existing differentiation in the criteria for the evaluation of estimates v. disclosures, and how we apply these criteria in practice. Although we can conceptually agree with the revised explanation of “reasonable” provided in paragraph A2, we believe such a definition leads to the need for the IAASB to further consider whether “reasonable” is the most appropriate term. Further, we believe there may be implications from this change for the auditor’s evaluation of disclosures not related to accounting estimates, including the auditor’s evaluation of misstatements in those disclosures (see Appendix 2 to our letter for further detail).
 - Paragraph 23, which has been extended to include specific evaluation of disclosures related to accounting estimates, does not provide any application material related to the auditor’s identification and evaluation of misstatements in qualitative disclosures. Qualitative disclosures are particularly prevalent in management’s disclosures about accounting estimates and such disclosures can be challenging to evaluate (see our response to Q6).
 - We do not support including in the requirements of ED-540 the auditor’s evaluation of whether disclosures beyond those required by the applicable financial reporting framework are necessary (see our response to Q6).
- We support the proposal to include guidance for the auditor’s consideration of the relevance and reliability of external information sources used by management in the preparation of accounting estimates, but we do not believe that incorporating such guidance into ISA 500³

³ ISA 500, *Audit Evidence*

(instead of ISA 540) will result in appropriate and consistent evaluations of such sources by the auditor (see our response to Q7).

We recognize that the US Public Company Accounting Oversight Board (US PCAOB) has issued a proposal to enhance its standards as it relates to auditing accounting estimates. We encourage the IAASB to proactively engage with the US PCAOB, to the extent possible, to reduce the risk of having two different internationally-applicable approaches to auditing estimates that may be difficult to reconcile and may lead to differing work efforts and documentation requirements, which would not be in the public interest.

Our responses to the specific questions and general matters on which the IAASB is seeking feedback are set out in Appendix 1 to this letter. Appendix 2 includes comments on other matters related to ED-540 for which we have substantive concerns or for which we believe greater clarity in ED-540 is particularly important to achieving appropriate and consistent implementation in practice. We also have a number of editorial observations and suggestions, which are set out in Appendix 3.

We would be pleased to discuss our comments with members of the IAASB or its staff. If you wish to do so, please contact Bob Landwehr, Deputy Director, Global Professional Practice (bob.landwehr@uk.ey.com).

Yours sincerely

Ernst + Young Global Limited

Appendix 1: Specific questions and general matters on which the IAASB is seeking feedback

Overall Questions

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

The enhancements to ED-540 are appropriate in many respects in relation to auditing accounting estimates that are prepared in accordance with financial reporting standards that continue to increase in their complexity. The comments that we make to the other questions in the ED, as well as in Appendix 2 to our letter, take into account the application of ED-540 to such estimates. Specifically, we believe the following enhancements are particularly relevant to the audit of accounting estimates that are prepared in accordance with increasingly complex financial reporting standards:

- We agree it is appropriate to require the auditor to test how management has made the accounting estimate when the inherent risk for the estimate is “not low”, which we believe is essentially the approach that paragraphs 17-19 of ED-540 are prescribing (see Q4 (c) for further comments in this regard).
- We support the change made to paragraph 19 (b) of ED-540 to recognize that when point estimates or ranges are developed by the auditor, they should be developed “to the extent possible”. We also support the related application material in paragraphs A128-A134. Specifically, the guidance in A134 that acknowledges that auditor ranges may be multiples of materiality is helpful because this reflects what a realistic outcome may be when the auditor develops ranges for accounting estimates subject to high estimation uncertainty. And, we agree with the emphasis on the auditor’s evaluation of disclosures related to estimation uncertainty in these circumstances. However see our response to Q5 for further suggestions to improve this paragraph.
- The additional guidance proposed for ISA 500 related to the auditor determining the reliability of external information sources is useful, particularly in the context of evaluating the fair value of financial instruments, and as it relates to evaluating assumptions and data used in preparing estimates that management obtains from external sources (e.g., economic indicators). However, see response to Q7 where we express the view that this guidance would be better placed in the context of accounting estimates, and thus included in ISA 540.

In addition to the enhancements proposed in ED-540, we believe ED-540 could benefit from additional enhancements that specifically recognize that certain financial reporting standards, such as IFRS 9, can be challenging for management to initially implement but also to prepare accounting estimates on a recurring basis in future periods that fully meet the requirements of the standards.

Due to the increasing complexity of financial reporting standards, we strongly agree that the auditor’s required understanding of the applicable financial reporting framework under paragraph 10 (a) in ED-540 is important. However, we believe further guidance could be provided, starting from the auditor’s risk assessment procedures, on the importance of the auditor giving explicit consideration to whether management’s process to make the accounting estimate represents the appropriate application of the requirements of the applicable financial reporting framework.

We find in practice that, when management’s processes are not as robust as expected in context of the requirements of the applicable financial reporting framework, this can have a significant impact on the

auditor's risk assessment and on the auditor's design of responsive audit procedures for the estimate. In this circumstance, the auditor taking an approach to solely test how management has made the estimate may not result in sufficient appropriate audit evidence, and it is possible that the auditor may need to supplement that testing by developing a point estimate or range, either for the estimate as a whole or in relation to certain components of the estimate.

Accordingly, we have the following suggestions for further enhancements to ED-540:

- Paragraph 10 (e), which requires the auditor to understand how management makes accounting estimates as part of risk assessment procedures, or its related application material, should be enhanced to draw a more explicit linkage to paragraph 10 (a) regarding the auditor's understanding of the applicable financial reporting framework, and the related possible effects on the auditor's risk assessment. Paragraphs A11-A13 to 10 (a) do not fully capture this relationship.
- Application material to paragraph 15 could be included to explain that the appropriateness of the auditor taking an approach to test how management has made the estimate is conditioned in part upon the results of the auditor's risk assessment procedures and whether the auditor believes that management's process achieves appropriate application of the requirements of the applicable financial reporting framework.
- For estimates for which the inherent risk is "not low", paragraph 19 requires the auditor to assess whether management has appropriately addressed estimation uncertainty, and if not, the auditor is required to develop a point estimate or range. We believe the application material to this requirement could be enhanced for the auditor to also take into account the results of the auditor's work (in accordance with paragraphs 17-18) to test how management has made the estimate in order for the auditor to consider whether development of a point estimate or range may be appropriate for reasons other than management's failure to appropriately address estimation uncertainty.

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

We have the following observations and suggestions regarding how ED-540 reinforces or could be further enhanced to reinforce the application of professional skepticism:

- When auditors take the approach of testing how management makes the accounting estimate, which is common for more complex and subjective estimates, the auditor is often focused on auditing the individual components of the estimate (i.e., method, assumptions and data). When doing so, it is quite useful for the auditor to also "stand back" and perform an overall evaluation of whether accounting estimates, both individually and in the aggregate, are appropriate in the context of the financial reporting framework. Therefore, we support the enhancements to the overall evaluations in paragraphs 22 and 23 of ED-540.
- We also support the addition to paragraph 23 for the auditor to consider all relevant audit evidence obtained, whether corroborative or contradictory, in making the overall evaluation of accounting estimates. However, we believe that more guidance could be provided earlier in ED-540 about how the auditor may deal with contradictory evidence when it is discovered in performing procedures, and prior to the stage of performing the overall evaluation of accounting estimates.

- Our suggested enhancements to ED-540 (that we have included in our response to Q1) to more explicitly link the auditor's understanding of the applicable financial reporting framework to the auditor's expectations for its application to accounting estimates in the entity's circumstances will, in our view, assist in promoting application of professional skepticism in the design and performance of the audit procedures, including better informing the auditor's judgment of whether the auditor may need to take the approach of developing a point estimate or a range.
- As expressed in our response to Q6, we believe more guidance is needed on the auditor's evaluation of qualitative disclosures. In our view, providing such guidance would contribute toward the goal of enhancing the appropriate application of professional skepticism when evaluating disclosures related to accounting estimates.

Focus on Risk Assessment and Responses

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

We recognize the introduction of a differentiation in the prescribed work effort based on the inherent risk assessment to be a new approach within the ISAs to explicitly address scalability of the auditor's procedures. We implemented a very similar approach in our EY Global Audit Methodology two years ago, under which we have prescribed procedures to address estimates with higher inherent risk. Our experience in practice has been that greater prescription in audit procedures for estimates with higher inherent risk promotes greater consistency in the nature of the work performed, in particular as it relates to evaluating estimation uncertainty, and focuses the auditor's attention on these higher risks of material misstatement. As it relates to lower risk estimates, we have found that allowing greater auditor discretion in the approach to auditing these estimates to be appropriate.

In considering ED-540, we believe further clarity is needed to fully implement the proposed risk-differentiated approach and for auditors and stakeholders to understand the IAASB's intentions for the scalability of the standard. Based on our experiences and input from our auditors on how ED-540 may be implemented in practice, we have the following observations and suggestions:

- In regard to the risk assessment procedures, the guidance from ISA 315 (Revised)⁴ within paragraph A10 that summarizes considerations relevant to smaller entities when performing risk assessment is useful. However, for accounting estimates, we would suggest also putting such considerations in the context of the nature of the estimate. For estimates that are non-complex or have lower estimation uncertainty, whether in smaller entities or larger entities, entities are likely to have simpler business processes and, as a result, the effort to perform the risk assessment procedures also will be less for these estimates in comparison to estimates of greater complexity.
- In regard to paragraph 15, it is not clear whether (a) or (b) applies when the inherent risk assessment for the estimate varies across the relevant assertions. For example, for some accounting estimates, the inherent risk assessment for the valuation assertion may be "not low", but the assessment for the other relevant assertions may be "low".
- We appreciate the flexibility provided in paragraph 15 (a) for the auditor to determine which testing approach is appropriate in the circumstances when inherent risk is "low" for the estimate. However, there is limited guidance in the standard on how the selected testing

⁴ ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*

approach may relate to the prescribed work effort in paragraphs 17-20 for estimates with “not low” inherent risk. In order to achieve consistency in how auditors address “low” inherent risk estimates, we believe clarification is needed.

In our view, when the auditor determines to take the approach of developing an auditor’s range for a “low” inherent risk estimate, the requirement in paragraph 20 that addresses the development of auditor ranges should apply. In addition, the application material that addresses the evaluation of management’s point estimate when either an auditor’s point estimate or range are used should apply. Similarly, when the auditor selects the approach of testing how management made the estimate, we believe the objectives in paragraphs 17-19 are relevant to the auditor’s design of further audit procedures. We would expect, however, that the extent of effort and the persuasiveness of the evidence obtained from the further audit procedures is less for estimates with “low” inherent risk (see further comments regarding our views on paragraphs 17-19 in our response to Q4).

Q4. *When inherent risk is not low (see paragraphs 13, 15, and 17-20):*

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

We believe that the requirements in paragraphs 13, 15 and 17-20 have the potential for supporting more effective identification and responses to risks of material misstatements for accounting estimates for which inherent risk is “not low”; however, we believe the approach is quite complicated and could be simplified without losing its intended objective. We are concerned about the practical implementation of a work effort driven by the individual applicability of the three factors of complexity, judgment and uncertainty to an accounting estimate. As noted in several places throughout the application material of ED-540 and in Appendix 2, these three factors have inherently overlapping characteristics. We are not convinced that the auditor needs to “draw lines” between the factors, as currently implied in these paragraphs, in order to design effective responses to the risks of material misstatement. To the contrary, we believe requiring the auditor to draw such clear distinctions runs the risk of auditors designing responses that are not sufficient for estimates that have “not low” inherent risk.

We include our further specific observations and suggestions related to simplifying and adjusting the approach taken in ED-540 in our responses to parts (b) and (c) of this question.

Significant risks

In implementing the approach in our audit methodology to prescribe procedures for accounting estimates for which inherent risk is “not low”, we reached a similar conclusion to that expressed in ED-540 related to significant risks. Specifically, the nature of the procedures applicable to the estimates for which inherent risk is “not low” are also applicable to estimates that are significant risks; the difference is in the extent of the procedures such that the auditor needs to obtain more persuasive evidence the higher the risk.

Despite our agreement with the approach taken in ED-540 for significant risks, we believe further clarification is necessary to explain how the more granular work effort in ED-540

relates to the requirement in ISA 330.21⁵ to perform procedures specifically responsive to significant risks. When the auditor designs responsive procedures (that appropriately include tests of details when required by ISA 330.21) to achieve the objective-based requirements of paragraphs 17-20 of ED-540, it is unclear whether the requirement in ISA 330.21 also is fulfilled. If not, clarification is needed to address further considerations the auditor should take into account to develop procedures specifically responsive to the significant risk.

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 use of judgment by management and the potential for management bias, and estimation uncertainty?

We support the introduction of the three factors of complexity, the use of judgment by management, and estimation uncertainty as explicit considerations in identifying and assessing the risks of material misstatement for accounting estimates, including the supplemental information about these factors presented in Appendix 2 to ED-540. Understanding the underlying reasons for the risk assessments is important to designing further audit procedures that are responsive to the risks, and we believe these factors can assist in driving increased consistency in the auditor's approach to risk assessment for accounting estimates.

Nevertheless, the wording of paragraph 13 that requires the auditor to take into account "the extent to which" the accounting estimate is subject to one or more of these factors seems to imply that the extent needs to be measured in some concrete manner, including the possibility that each factor may require a separate risk assessment of some sort. If this is the intention, we do not support such an approach because not only do these factors have inherently overlapping characteristics that makes drawing clear distinctions between them difficult and impractical, but drawing such clear distinctions is not necessary in order to design appropriately responsive audit procedures (see part (c) for our further views in this regard).

In our view, the auditor should gather information during the risk assessment procedures performed in accordance with paragraph 10 about the complexity, judgment and estimation uncertainty related to the accounting estimate, and then the auditor should take into account the nature of the estimate (which is affected by these three factors) in making the risk assessments at the assertion level for the estimate. In designing the audit procedures responsive to the risks, the auditor should also take into account the nature of the estimate and the underlying effects of these three factors (see part (c) of this question for further views), as well as the appropriateness of management's process to make the estimate (see our response to Q1).

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?

No, in our view, there is a missing critical relationship in ED-540 between the objectives-based requirements in paragraphs 17-19 and the three available testing approaches for accounting estimates for which inherent risk is "low". We believe the objectives-based requirements in paragraphs 17-19 (a) are essentially requiring the auditor to take the approach of testing how management made the accounting estimate and the data on which it is based. Further, paragraph 19 (b) requires the auditor to develop a point estimate or range when certain

⁵ ISA 330, *The Auditor's Responses to Assessed Risks*

conditions are met. In order to bring sufficient clarity to the risk-differentiated approach in ED-540, we strongly believe it is necessary to place the objectives-based requirements in the context of the testing approaches that are proposed to only be relevant to accounting estimates for which inherent risk is “low”.

Similar to our views on the testing approaches, we also believe the objectives-based requirements are not exclusively relevant to estimates for which inherent risk is “not low” as expressed in our response to Q3. Further, we do not agree that the objectives presented as applicable only when complexity or judgment is driving the inherent risk for the estimate are only applicable in those circumstances. In our view, any accounting estimate for which the auditor intends, or is required to, test how management has made the accounting estimate should involve the auditor performing procedures to evaluate the underlying method, data and assumptions (which together may be implemented into a model) of the estimate. When any of these underlying components of the estimate are more or less complex, or more or less judgmental, or subject to more or less estimation uncertainty, then the auditor’s procedures to evaluate those components should be scaled accordingly to reflect the nature of the estimate.

To summarize, we suggest amendments to the approach to further audit procedures for accounting estimates for which the inherent risk is “not low” in ED-540 that include:

- Paragraph 15 (b) of ED-540 requiring the auditor to test how management made the accounting estimate and the data on which it is based by performing further audit procedures to achieve the objective-based requirements.
- Conflating the objectives-based requirements in paragraphs 17-19 (a) into a single list focused on the underlying components of accounting estimates (i.e., method, significant data, significant assumptions, model) accompanied by appropriate evaluations of estimation uncertainty that arise from these underlying components. We believe this change in structure will also provide a better basis for providing guidance on the auditor’s evaluation of external information sources used by management in the preparation of estimates (see our response to Q7 for further details on our concerns about the approach taken in ED-540 to amend ISA 500).
- Removing the concept of “complex models” from the objective-based requirements in 18 (c) and converting these into an objective-based requirement related to the auditor’s evaluation of management’s use of modeling more broadly.
- Adding application material that explains how the procedures for the individual objectives may be scaled depending on the nature of the accounting estimate, including taking into account the information obtained during risk assessment about complexity, judgment and estimation uncertainty.

We also believe that “significant assumptions” should be a defined term in ED-540 and we are not convinced that the term “significant data” is necessary (refer to Appendix 2 for further details of our views in this regard). Refer also to our response to Q1 for our suggestions regarding additional application material for paragraph 19.

Q5. *Does the requirement in paragraph 20 (and related application material in paragraphs A128-A134) appropriately establish how the auditor’s range should be developed? Will this approach be more effective than the approach of “narrowing*

the range”, as in extant ISA 540, in evaluating whether management’s point estimate is reasonable or misstated?

Yes, we believe that the requirement in paragraph 20 and related application material in paragraphs A128-A134 have been enhanced and improved from extant ISA 540. In particular, we support the requirement for the auditor’s range being stated in the form of an objective, because it is important for the auditor to focus on determining that the range is supported by audit evidence and is reasonable in context of the applicable financial reporting framework.

We have the following additional comments:

- Paragraph A132 explains that it is important that the auditor obtain a sufficient understanding of the data, assumptions and method used by management in making the accounting estimate because this information is relevant to the auditor’s development of an appropriate point estimate or range. We would agree, and for accounting estimates for which the inherent risk is “not low”, we believe requiring the auditor to perform procedures to test how management made the estimate (as we expressed in our response to Q4 (c)) would achieve this objective.
- Per paragraph 15 (b), paragraph 20 is required only for accounting estimates that have an inherent risk of “not low”. As we express in our response to Q3, when the auditor selects the approach to develop a range for estimates for which the inherent is “low”, we believe that paragraph 20 should apply.
- As we express in our response to Q1, we strongly support the explanation in paragraph A134 that auditor ranges may possibly be multiples of materiality. And, we agree that the auditor’s evaluation of the reasonableness of the disclosures about estimation uncertainty becomes “important”. However, instead of referring to the “importance” of such evaluation, we believe it would be more useful to explain the basis for the importance. Such guidance may include, for example, explaining that, in executing paragraph 23 as it relates to evaluating the reasonableness of disclosures, the auditor may give specific consideration to whether sufficient information about the extent of estimation uncertainty has been disclosed, and whether the qualitative disclosures, in particular, appropriately assist users’ understanding about the nature and extent of estimation uncertainty. If the disclosures are insufficient, the auditor may determine that misstatements exist (refer to our response to Q6 for our further views on enhancements to the application material to specifically address evaluating qualitative disclosures).

Q6. *Will the requirement in paragraph 23 and related application material (see paragraphs A2-A3 and A142-A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate?*

Determination of misstatements

We believe that the application material in paragraphs A142-A146 is helpful as it relates to determining misstatements in accounting estimates. In particular, paragraph A145 is quite clear as to how misstatements are to be calculated in comparison to an auditor’s point estimate or auditor’s range, and this guidance should result in a consistent determination of misstatements when an auditor’s point estimate or range is used in evaluating the estimate.

However, we do not believe that paragraph 23 will result in more consistent determination of misstatements in disclosures related to accounting estimates, particularly qualitative disclosures. As noted in paragraph A2 of ED-540, the applicable financial reporting framework typically requires qualitative disclosures about accounting estimates, including how they are made and the degree of estimation uncertainty related to them. Evaluating the nature and extent of management's disclosures against the criteria of the financial reporting framework, which may be objective-based, can be quite challenging in practice, including as it relates to identifying misstatements in those disclosures. In ED-540, paragraph 23 does not have any application material that addresses or assists with identifying misstatements in qualitative disclosures, which in our view is a critical gap in light of the fact that the evaluation in paragraph 23 has been specifically extended to include evaluation of disclosures.

Supporting explanations of reasonable and appropriate in paragraphs A2-A3

We find it useful that paragraphs A2 and A3 provide explanations of the terms "reasonable" and "appropriate" in the context of management's compliance with the applicable financial reporting framework. In Appendix 2 to this letter, however, we raise further questions about the use of the term "reasonable" as it relates to the auditor's evaluation of disclosures and we encourage the IAASB to consider the implications of this change in terminology more holistically across the ISAs.

Other observations about the evaluation of the reasonableness of accounting estimates and related disclosures

- We support the addition to paragraph 23 regarding the consideration of all relevant audit evidence, whether corroborative or contradictory, as we express in our response to Q2. However, we believe the last sentence of paragraph 23 appears to be misplaced because it addresses the implications of the auditor not obtaining sufficient appropriate audit evidence. These implications seem to be more closely related to evaluations performed in paragraphs 21 and 22 of ED-540.
- We do not believe the determination of whether disclosures beyond those required by the financial reporting framework, which is currently included in paragraph 21 of ED-540, should be included in the requirements of ED-540. Including this evaluation in the requirements, in our view, de-emphasizes the importance of the auditor's evaluation of whether the disclosures are in accordance with the requirements of the financial reporting framework, which we believe is challenging in itself, as previously noted. We also contend that the need for the auditor to focus on the disclosures in the context of the applicable financial reporting framework is further evidenced by certain initiatives by accounting standard-setters, such as the International Accounting Standards Board's disclosure effectiveness project, that recognize the challenges for management to prepare informative and tailored disclosures while achieving the right balance in the detail of such disclosures.

Because paragraphs 13 and 14 of ISA 700 (Revised)⁶ address the auditor's evaluation of fair presentation of the financial statements, including the disclosures, we believe it would be more appropriate for the application material in ED-540 to address and explain the relationship of the required overall evaluation of estimates and related disclosures to the evaluation of fair presentation in ISA 700 (Revised). In this regard, we believe such application material would be best placed in support of the overall evaluation in paragraph 23 of ED-540 and not paragraph 21, which addresses the separate evaluation of whether sufficient appropriate audit evidence has been obtained.

⁶ ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*

Conforming and Consequential Amendments

Q7. With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?

No, we do not believe the amendments to ISA 500 will achieve the intended objective of the auditor more appropriately and consistently evaluating the relevance and reliability of information from external information sources. To summarize, our concerns are related to:

- The risk of inconsistency in the auditor's work effort related to external information sources because the proposed application material provides many different approaches to "considering" the relevance and reliability of external information sources without putting such considerations in sufficient context of the nature and purpose of the external information source used by management
- As it relates to the use of third party pricing sources and other external information sources that are used in management's preparation of accounting estimates, there is a lack of guidance on the relationship between the degree of estimation uncertainty that arises from the specific assumption or data for which management has used an external information source, and the nature and extent of work effort required to consider the reliability of that external information source

The proposed amendment to include external information sources within Paragraph 7 of ISA 500 requires that the auditor *consider* the relevance and reliability of the information to be used as audit evidence from the external information source. This amendment is supported by a substantial amount of new application material that, in our view, suggests a wide variation in the possible nature and extent of the work effort for this "consideration" that may, in fact, go significantly beyond consideration in certain circumstances.

We agree that there may be significant variability in the work effort necessary for the auditor's evaluation of an external information source, which means that there is a need for guidance that assists the auditor in determining the nature and extent of work required given the context in which management is using the external information source and the nature of the information provided by the source. Although we understand the proposed placement of this guidance in ISA 500 is so that the guidance will apply broadly to any external information source used by management, we do not believe the proposed application material in paragraphs A33B-A33G in ISA 500 provides adequate explanation as to why and when the different approaches to considering the external information source are likely to be necessary.

As it relates to ISA 540, we believe there is a need for guidance that is specific to management's use of external information sources in its preparation of accounting estimates. In our view, there is a direct relationship between the degree of estimation uncertainty in an accounting estimate, and the work effort associated with the external information sources that are used in that valuation. For example, investments that have observable market prices and recent identical transactions that are used in determining their fair value involve a lower degree of estimation uncertainty. In addition, management is likely to have multiple external information sources from which to obtain reliable information. Under these circumstances, the auditor's procedures for considering the reliability of the source used by management in valuing the investment may be limited to considering the reputation of the source and obtaining a corroborating price from another source. However, for investments that do not have recent identical transactions to use for valuation purposes, management may need to use an external

information source to obtain similar transaction data. Depending on the nature of the data available, this valuation scenario may result in greater estimation uncertainty for the investment valuation, which in turn would drive a greater work effort by the auditor to evaluate whether the similar transaction data is relevant and reliable for its intended purpose.

It is also important to note that although external pricing sources are often discussed in the context of investment valuation, there are other relevant applications that are worth consideration as the IAASB further develops the guidance. For example, for entities that value commodities, such as oil and gas entities, management often develops internal pricing projections based on a combination of observable and unobservable inputs, such as futures or swap pricing on public commodity exchanges, investment bank forecasts, reports from analysts and their own internal economic projections. As a result, such pricing assumptions involve high degrees of estimation uncertainty and management judgment, which can result in a higher risk of management bias.

In our view, the guidance in ED-540 should be clarified to explain that estimation uncertainty increases based on the degree of divergence in the views among market participants regarding a specific input that is obtained externally by management and used in the valuation of an accounting estimate. Accordingly, when management uses an external information source to obtain an input for an estimate for which there is a wide variation in views among market participants, the auditor's procedures to address the relevance and reliability of that input will need to consider the variability that exists in that input and the resulting variability in management's estimate in order to determine the nature and extent of work necessary to consider the reliability of the particular source used by management.

Clarity is specifically needed on the auditor's appropriate consideration of the reliability of management's external information source when there are divergent market views related to an input, which may be the case for certain forward-looking economic factors used in, for example, estimating expected credit losses or in commodity pricing, and it is difficult or not possible to substantiate that one market view is more appropriate than another. In the example above related to oil pricing assumptions, the auditor's consideration of the appropriateness of management's input may include the extent to which management's pricing assumptions vary from the mean or median value from the external sources most commonly referenced in the industry. This may be an indicator of potential management bias.

Depending on the estimation uncertainty that arises from such assumptions or inputs that are subject to divergent market views, we believe the auditor would perform procedures to determine that the source of the input used is reputable and that the value of the input is appropriate in the entity's circumstances. In addition, the auditor would consider whether management's selection of the value to be used appears to be influenced by management bias. Then, the auditor would likely turn to considering the thoroughness and transparency of management's disclosures around the assumptions and data used in its estimate.

In summary, we recommend the IAASB:

- Develop guidance specific to the use of external information sources in management's preparation of accounting estimates within ISA 540 itself that sets forth considerations for the auditor's work in the context of the nature of the input, and the associated degree of estimation uncertainty that arises from that input. It would also be helpful to include specific examples related to the fair value of financial instruments as well as related to management's use of external information sources for certain significant assumptions or data.

- Further explore amendments to ISA 500 to deal with external information sources more broadly as part of the IAASB's planned audit evidence project, including giving specific consideration to the use of external information sources by both management and auditors in performing data analytics

Request for General Comments

Q8. *In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:*

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

No comment.

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.*

As ED-540 includes significant enhancements to the risk assessment process for accounting estimates, which may be performed early in the financial period (e.g., within the first six months of the financial period in the case of many audits), we believe the IAASB should consider an effective date that allows sufficient time for implementation for audits of financial statements for periods *beginning* after a certain date (in our view, at least twelve months after approval). However, we do agree that earlier application should be permitted.

Appendix 2: Comments on other matters related to ED-540

Adequacy v. reasonableness of disclosures related to accounting estimates

Paragraph 11 of the explanatory memorandum explains that “the IAASB concluded that both the accounting estimate and the related disclosures should be ‘reasonable’ in the context of the applicable financial reporting framework, as continuing to use ‘adequate’ may inappropriately suggest that disclosures are less important than the accounting estimate itself.” Although we acknowledge that this may be a possible interpretation of the extant objective of ISA 540, we do not share this view. In practice, the current use of the term “reasonable” as it relates to evaluating accounting estimates is understood to mean that the auditor is to specifically consider estimation uncertainty inherent in the accounting estimate and whether the resulting valuation is appropriate. We note that the ISAs currently only use the term “reasonable” in the context of evaluating fair presentation as a criterion for accounting estimates, and we have always believed this to be intentional and appropriate. It follows that, in practice, because disclosures related to accounting estimates are not subject to estimation uncertainty, the auditor’s evaluation objective has been intentionally different, and that is to determine whether such disclosures are “adequate” in the context of the requirements of the applicable financial reporting framework.

We note that paragraph A2 of ED-540 puts forth a definition of “reasonable, in the context of the financial reporting framework” that “all the relevant requirements of the financial reporting framework have been applied appropriately”, and that this definition applies to both accounting estimates and related disclosures in the financial statements. We can support this new explanation, particularly that both estimates and disclosures are evaluated using the context of the requirements of the applicable financial reporting framework. In fact, in our view, this definition is clearer than the term that is being defined (i.e. “reasonable”).

In light of this revised explanation, we would support, and strongly encourage the IAASB to consider, replacing the term “reasonable” with a phrase that explains that the relevant requirements of the applicable financial reporting framework have been appropriately applied. We believe this would be a useful clarification for ED-540 to achieve consistency in both the auditor’s evaluation of estimates and in stakeholder expectations regarding how estimates and related disclosures are evaluated by auditors.

Regardless of whether the IAASB changes the criterion for evaluation of estimates and related disclosures in ISA 540 to “reasonable” as proposed and newly defined, or in line with our recommendation to use the clearer language found in the definition in paragraph A2, we believe further holistic consideration across the ISAs of the effect of such change is necessary. This is because we find that the new explanation of “reasonable” would not apply exclusively to estimates and related disclosures, but would be applicable to all amounts and related disclosures throughout the financial statements. Consideration across the ISAs of the effect of the change should be specifically given to the:

- *Implications for the evaluation of disclosures in the financial statements that are not related to accounting estimates.* In principle, we believe that there needs to be common criteria and terminology for the evaluation of all disclosures in the financial statements in order for a consistent evaluation of fair presentation. We do not support an evaluation of disclosures related to accounting estimates that uses what appears to be a higher threshold for fair presentation than the evaluation of other disclosures in the financial statements.

- *Implications for the auditor's evaluation of misstatements in disclosures.* Paragraphs A17 of ISA 450⁷, and A3 and A7 of ISA 705 (Revised)⁸ address evaluating whether misstatements in disclosures are material. This application material, which is not referenced in ED-540, speaks to the appropriateness, accuracy and adequacy of disclosures, and it is unclear how the IAASB's proposed change in ED-540 to evaluate their "reasonableness" affects the auditor's evaluation of material misstatements in accordance with ISA 450. This disparity in terminology runs the risk of the auditor making inappropriate judgments about whether the financial statements are materially misstated. As expressed, we believe the terminology for evaluation of disclosures, if changes are pursued in conjunction with ED-540, needs to be aligned across the ISAs, in particular across ED-540, ISA 450, ISA 700 (Revised) and ISA 705 (Revised).

We note that Paragraph 13 of the explanatory memorandum recognizes the degree of inconsistency between the revised criterion in ED-540 and that in paragraph 13 of ISA 700 (Revised), which addresses the auditor's evaluation of the fair presentation of the financial statements, and the intention of the IAASB to further consider conforming amendments to ISA 700 (Revised) as part of the post-implementation review for auditor reporting. It is not clear exactly what conforming amendments to ISA 700 (Revised) are being considered. However, we would not support a conforming amendment to simply change paragraph 13 (c) to read "the accounting estimates and related disclosures are reasonable" based on the views previously expressed in this letter.

To summarize, our primary concern is the use of different terminology across the ISAs as it relates to evaluating disclosures, which we believe will be confusing in practice and may result in inconsistencies in the evaluation of the fair presentation of the financial statements, which would not be in the public interest. We suggest the IAASB consider whether the terms "reasonable", "appropriate", and "adequate", could be equally and consistently replaced throughout the ISAs with the concept of appropriate application of the requirements of the applicable financial reporting framework. Should the IAASB determine that a change is not appropriate across the ISAs at this time, we recommend that the proposed change in the criterion for the evaluation of disclosures related to accounting estimates be reverted to the extant criterion of "adequate".

Significant data and significant assumptions

We note that the auditor's evaluation of significant assumptions has been emphasized in ED-540 along with a much greater prominence of the auditor's evaluation of the data used in accounting estimates, which includes introducing a new term of "significant data".

In ED-540, an explanation that seems to be relevant to both terms is included in paragraph A35. In regard to significant assumptions, the extent to which the variation in the assumption would materially affect the measurement of the accounting estimate is a key criterion, but we believe there are further possible considerations relevant to determining whether an assumption is significant. These may include whether the assumption involves unobservable data, or the extent to which the assumption is a source of estimation uncertainty, or the extent the assumption may be susceptible to management bias. Due to the increased prominence of the term "significant assumption" throughout ED-540 and the increased requirements for the auditor to evaluate significant assumptions, we believe that this term should be a defined term in ED-540 so that the concept is consistently understood and applied in practice.

⁷ ISA 450, *Evaluation of Misstatements Identified during the Audit*

⁸ ISA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*

In regard to significant data, we do not believe that the explanation put forth in paragraph A35 is appropriate. Data sets may inherently have wide variations in them, which does not make the data any more or less “significant”. In our view, the auditor should consider the relevance and reliability of the data used, regardless of its “significance” to the accounting estimate. As a result, we are uncertain what is meant by “significant data” as opposed to the relevant data used in preparing the accounting estimate. We do not believe that management has a choice in data in the same manner that management may have a choice in assumptions and therefore the same definition and evaluation criteria should not apply. In our view, the new concept of “significant data” is not capable of being consistently implemented in practice based on the requirements in ED-540, and therefore we strongly encourage the IAASB to consider whether such a scaled concept for data used in preparing accounting estimates is truly necessary.

Management representations

We agree with broadening the current required representation from management that addresses only the significant assumptions of accounting estimates to address management’s preparation of the estimates more holistically. However, we have concerns about requiring management representations related to:

- *The “reasonableness” of the estimate and its related disclosures in context of the financial reporting framework.* “Reasonableness” is currently the auditor’s objective in ED-540 and is defined in the context of the audit of accounting estimates; management should not be requested to provide representations in relation to the audit objective. We believe it would be more appropriate for management representations to address whether the relevant requirements of the applicable financial reporting framework have been appropriately applied in the preparation of the accounting estimates and the related disclosures.
- *Significant data and significant assumptions.* As noted above, we believe the term “significant assumption” is in need of a clear definition due to its increased prominence in ED-540, and this, must also be clear to management in order for management to be able to make representations about them. Regarding “significant data”, we do not believe it is necessary to include “significant data” in management’s representations regardless of whether the term is retained in ED-540. Any required representations about data should focus on the source and integrity of the data used in preparing the accounting estimate, without regard to its “significance”.

Risk assessment procedures

We have the following comments related to the enhancements to the risk assessment procedures in paragraph 10 of ED-540 and related application material:

- Paragraph 10 (b) – We agree with the addition of regulatory factors as a required consideration for risk assessment of accounting estimates, but we believe that the application material should acknowledge that ED-540 also applies to audits of special purpose financial statements in accordance with ISA 800 (Revised)⁹, which may be the case when the entity is required to report in accordance with a regulatory framework instead of a general purpose framework. In such audits, the auditor should rightfully be focused on compliance with the regulatory framework.
- Paragraph 10 (c) – We do not support the proposed risk assessment procedure for the auditor to understand the nature of accounting estimates and related disclosures “to be expected” in the

⁹ ISA 800 (Revised), *Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*

financial statements. We believe this requirement is inconsistent with ISA 315 (Revised). ISA 315 (Revised) does not impose a requirement to form an expectation of accounts or disclosures in the financial statements; it requires the auditor to obtain an understanding of the entity and its environment so that the auditor has an expectation of the accounts and disclosures in the financial statements (i.e., it is a rationale for the understanding of the entity and its environment and is not an audit procedure on its own).

- Paragraph 10 (f) – We do not support expanding the current required understanding of “relevant controls” to include understanding “each of the components of internal control as they relate to making accounting estimates” because:
 - *This creates redundancy in the requirements.* We believe the relevant understanding of the risk assessment process component of internal control is already covered by paragraph 10 (d) and that the relevant understanding of the information system component of internal control is covered by paragraph 10 (e).
 - *The new application material to this requirement addresses the relevance of the control environment only.* We would agree that the auditor should consider the effect of the entity’s control environment on management’s preparation of accounting estimates. In order to reflect this necessary consideration in the requirements, we would suggest reverting paragraph 10 (f) to “relevant controls” and inserting a new paragraph 10 (a) focused on the effect of the control environment.
 - *This change loses the connection to the required identification of controls relevant to the audit in ISA 315 (Revised).* Identification and understanding of controls relevant to accounting estimates is important to the auditor’s assessment of the risks of material misstatement for the relevant assertions for accounting estimates. “Relevant controls” also include those that address significant risks, which often relate to accounting estimates. We believe that the emphasis on identifying and understanding controls relevant to accounting estimates should not be lost.
- The application material to paragraph 10 has been substantially expanded and enhanced. In light of the IAASB’s concurrent project on ISA 315 (Revised), we encourage consideration of whether some of this new guidance may apply more broadly to risk assessment across the financial statements (and not just to accounting estimates) and, if so, whether this guidance would be better placed in ISA 315 (Revised). In some respects, it may appear that ED-540 is setting expectations for risk assessment procedures above and beyond what ISA 315 (Revised) may be believed to require. Further, we encourage the IAASB to ensure that there is close coordination between the two projects to reduce the risk of significant conforming amendments to ISA 540 after its revision to accommodate changes in ISA 315 (Revised), to the extent that such changes can be foreseen.

Documentation

Although we acknowledge that ISA 230¹⁰ sets forth overall requirements for audit documentation, we believe it is important to clarify the requirements for documentation specifically related to accounting estimates. Paragraph A158 of ED-540 seems to include expectations for documentation that go beyond paragraph 27 of ED-540. We encourage the IAASB to be clear in the requirements of ED-540 as to the documentation expected, even when such documentation may be viewed to fall within the scope of a broader requirement of ISA 230, in order to promote consistency across audits, and in stakeholder expectations, related to audit documentation.

¹⁰ ISA 230, *Audit Documentation*

Appendix 3: Editorial suggestions and observations

ISA 540 paragraph reference	Observation/suggestion	Rationale
4	This ISA focuses the auditor's attention on, <u>in relation to accounting estimates</u> , designing and performing further audit procedures...	Clarification that the scope of 540 is limited to accounting estimates
5	The application of professional skepticism by the auditor is particularly important to the auditor's work related to accounting estimates. Professional skepticism also is important because there is a particular risk of management bias affecting accounting estimates due to their subjective, potentially complex and uncertain nature.	As written, the second sentence implies that the first sentence included a reason for the importance of professional skepticism, which it does not.
10 (e)	How management makes accounting estimates, including: ... (v) How the risk of management bias is identified <u>assessed</u> (vi) How management has addressed <u>assesses</u> estimation uncertainty; and (vii) How management has addressed <u>assesses</u> the need for a change from the prior period.....	As these are risk assessment procedures, we believe the auditor should be understanding how management assesses these areas and not how management has addressed them (which would be a substantive procedure)
A1	Examples of situations where accounting estimates <u>that may be required by the applicable financial reporting framework</u> include: <ul style="list-style-type: none"> · Inventory obsolescence · 	To provide the explicit context of the requirements of the applicable financial reporting framework
A2	... means that all the relevant requirements of the applicable financial reporting framework have been addressed appropriately, including those that address . The requirements of the applicable financial reporting framework may include requirements that address:	As written, the requirement implies that all frameworks would include specific requirements related to the bullets that follow.
A5	An auditor's point estimate or range may be developed for an accounting estimate as a whole (for example, the expected credit losses for a particular loan portfolio <u>the impairment of an asset</u> or the fair value.....	We do not believe that a point estimate or range is likely to be applied to an entity's expected credit loss estimate as a whole, and the application to a particular portfolio of the entity's loans would not represent application to the estimate as a whole.

ISA 540 paragraph reference	Observation/suggestion	Rationale
A12	Depending on the circumstances, it may be possible for the accounting estimate to be determined directly....	The meaning of “determined directly” is not clear
A12, or it may be possible <u>for management to select a management point estimate only after considering...</u>	To clarify that management selects the point estimate, not the auditor
A14	Obtaining an understanding of the regulatory factors that are relevant to accounting estimates..... may assist the auditor in determining whether the regulatory framework: <ul style="list-style-type: none"> • ... • Provides an indication of areas for which there may be a potential for management bias <u>towards consistency between to meet regulatory requirements reporting and financial reporting to the extent the respective requirements will allow</u> 	A suggested clarification to reflect the motivation by management that we encounter in practice
A39	Examples of data include: <ul style="list-style-type: none"> • ... • <u>In respect of expected credit losses, examples include default rates, credit ratings (including evolution of the rating through the loan life), days past due, collateral value based on appraisals, risk management categories specified by the entity</u> 	To provide additional examples of data specific to accounting estimates related to expected credit losses
A43	A failure by management to apply the required skills or knowledge, including engaging an expert....., <u>increases control risk may constitute a deficiency in internal control</u>	To clarify that such failure by management may be a deficiency in internal control (and to remove reference to control risk because ISA 540 does not require a separate assessment of control risk)
A50	The <u>Relevance of the Control Environment Relevant to Making Accounting Estimates</u> The auditor’s understanding of the control environment <u>relevant to making accounting estimates</u> includes considerations of the influence that the elements of the control environment would be expected to have on the risks of material misstatement, <u>including as it relates to accounting estimates.</u>	To clarify that there is a single control environment within the entity, and not a separate control environment for accounting estimates
A54	<u>In considering the relevance of the control environment to accounting estimates, t</u> The	To clarify that oversight of estimates by those charged with

ISA 540 paragraph reference	Observation/suggestion	Rationale
	oversight of the financial reporting process by those charged with governance may be particularly important for include oversight of management's preparation of accounting estimates that, in particular:	governance would be part of their oversight of the financial reporting process and that such oversight may be focused on higher risk estimates
A82	<ul style="list-style-type: none"> The integrity of the information systems. Data that is used to make the accounting estimates may be processed by information systems that may require effective general IT controls, and for which controls over the flow of data through the system <u>together with relevant general IT controls may be necessary to maintain data integrity.</u> 	To clarify how the controls identified contribute towards data integrity.
A108	The auditor's consideration of a change in an accounting estimate, or in the method for making it from previous periods, is important because a <u>A change from previous periods in the method, or significant data or significant assumptions, that is not based on a change in circumstances or new information is unlikely to be reasonable.....</u>	To align the application material to the revised requirement which does not focus on changes in the estimate, rather the changes in the method, significant assumptions or significant data
A114	There is no <u>may not be</u> a particular method of addressing estimation uncertainty that is more suitable than another. For example, management may employ sensitivity analysis, scenario analysis, or, when more robust evaluation is considered necessary (for example, in the banking or insurance industries), stress testing and or reverse stress testing.	To clarify that all methods may be suitable in certain circumstances, and that sensitivity analysis and scenario analysis are valid methods for banking and insurance industries.
A126	When the auditor believes that management has not appropriately understood or addressed estimation uncertainty, the auditor may consider requesting management <u>to take steps to address it, for example, by to considering alternative assumptions or to by providing additional disclosure relating to the estimation uncertainty.</u>	To clarify that the auditor's primary action should be to request management to address the estimation uncertainty and that there may be more alternatives to those that are mentioned in this paragraph