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Dear Matt

Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures

CPA Australia welcomes the opportunity to respond to this Exposure Draft. CPA Australia represents the diverse interests of more than 160,000 members in 118 countries. Our vision is to make CPA Australia the global accountancy designation for strategic business leaders. We make this submission on behalf of our members and in the broader public interest.

We support the IAASB's intention to ensure that the auditing standards remain relevant and reflect changes to the accounting standards.

Clarity, Understandability and Practicality of the ED

The IAASB has asked for comments on the clarity, understandability and practicality of application of the requirements and related application material of ED-540, in addition to the specific questions posed, which we address below.

We consider that clarity and understandability of the standard is hampered by its length, wordiness and the presence of some duplication. We would suggest that to avoid the lengthy and overly prescriptive requirements, as for example is the case with paragraphs 17, 18 and 19, some of the content is moved to application material, and the wording is made more concise in both the requirements and the application material.

With respect to practicality of application, we do not consider that the concepts of low risk and not low risk (para.15) provide a practical basis for scaling the requirements to the engagement. We consider that the threshold is too low in that the majority of estimates are likely to be considered not low risk and that the contrast in the required response between low risk and not low risk is too significant. An assessment of not low risk results in auditors being required to consider a long list of matters depending on whether the assessed risk is a result of complexity, management judgment and/or estimation uncertainty. In addition, the requirements to consider matters listed under complexity (para.17), judgement (para.18) and estimation uncertainty (para.19) separately are not practical as these three factors are closely related and usually not mutually exclusive. Consequently, auditors will often be required to ensure they have addressed and documented the three separate lists of matters in those paragraphs. This is not practical

as it does not allow for professional judgment in determining which matters are relevant to the engagement circumstances, but instead requires the auditor to obtain sufficient appropriate audit evidence on all of the matters listed, if the factor applies. As a consequence, the impact of the requirements is likely to be unnecessarily onerous without any evidence that it would lead to improved audit quality.

Overall Questions

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

CPA Australia acknowledges that ED-540 seeks to address the auditor's considerations relevant to the new International Financial Reporting Standards, including IFRS 9 *Financial Instruments*, which give rise to greater estimation uncertainty. However, in doing so the proposed standard has become overly lengthy and complex. This has resulted in an overly prescriptive standard which cannot be easily scaled for smaller entities.

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

Effective exercise of professional scepticism is particularly relevant when auditing accounting estimates, which we agree is unlikely to be achieved by simply calling for greater professional scepticism. Therefore, we support the IAASB's approach of including auditor actions which reflect how exercise of professional scepticism would manifest in auditing of accounting estimates in ED-540. In particular, we support the enhanced risk assessment requirements, more precise requirements with respect to obtaining audit evidence, and requirements to "stand back" and evaluate the audit evidence obtained. We, however, consider that the concept of standing back could be more clearly articulated or expressly stated in paragraph 22.

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 do not consider that scalability is adequately achieved in ED-540. The IAASB has sought to achieve scalability by providing a separate approach for low risk and not low risk and then breaking down work effort for not low risk into three factors: complexity, management judgment and estimation uncertainty. We consider that the majority of estimates, by their very nature, will fall into the not low risk category and for many of these all three factors will apply. Rather than using professional judgement to determine the nature, timing and extent of procedures necessary in the circumstances, auditors will then be required to conduct all of the procedures listed in paragraphs 17, 18 and 19 or document why any of the procedures are not applicable. Whilst we acknowledge that the three factors are relevant to accounting estimates, they are not often mutually exclusive. The first factor, complexity, the use of a complex model or specialized skills or knowledge, would normally necessitate the second factor, being the need for use of judgement by management, which would often result in the third factor, estimation uncertainty. Consequently, we do not consider dividing the procedures in three categories is effective in scaling the work effort. There is no escaping the need for professional judgement to determine the evidence needed in each circumstance. We would argue that the level of risk is more akin to a sliding scale rather than binary concept of either low or not low risk.

In addition, the concepts of low and not low risk are inconsistent with ISA 315 (Revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, which requires the risks of material misstatement to be identified and assessed, at the financial statement and assertion levels, and to determine whether any are significant risks. We consider that it is important, if a new approach to risk is to be introduced, that this is considered through the revision process for ISA 315. This would enable a consistent underlying approach to risk assessment applicable across the entire audit not just one aspect. Nevertheless, regardless of due process, we do not consider this binary view of risk is helpful nor applicable across the entire audit, so we would not be supportive of this concept being adopted in ISA 315.

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?*

We agree that paragraph 13 supports a more effective identification and assessment of risks. However, the requirements that follow should be based on the requirements of ISA 315, specifically regarding the risks of material misstatement identified at both the financial statement and assertion level. Likewise, paragraph 15 notes that ISA 330 requires the auditor to respond to assessed risks of material misstatement, including significant risks, at the assertion level, but then the requirements that follow are not based on the ISA 330 requirements. Assertions seem to be overlooked in the requirements that are listed and yet it would be very helpful if the risks relevant to accounting estimates relating to relevant assertions were drawn out. Instead, the requirement to address the three factors of complexity, management judgment and estimation uncertainty have effectively replaced consideration of assertions.

We consider that the delineation between low and not low risk in paragraph 15 and between complexity, judgment and estimation uncertainty in paragraphs 17-19 does not provide a practical means of determining adequate responses to assessed risk. The outcome of these requirements may be that auditors apply a check list approach because the list of matters on which sufficient appropriate audit evidence is required is so prescriptive and extensive.

The matters listed in paragraphs 17-19 would be better placed in application material and the three factors of complexity, judgment and estimation uncertainty not presented as mutually exclusive, but acknowledged to be overlapping and interrelated considerations.

In addition, paragraph 19(b) suggests an increase in the auditor's responsibility, in requiring development of a point estimate or range when management has failed to understand or address estimation uncertainty, even if it may be appropriate for the auditor to qualify their report.

- 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?*

We do support the requirement for the auditor to take into account these three factors. However, in considering the relevance and impact of these factors, it may not be necessary to separate the low risk from not low risk estimates, as the risks or absence of risk should drive the response. We

do not see the benefit of an “all or nothing” approach which seems to characterise the artificial low/not low risk delineation.

Management bias seems to be inconsistently linked to management judgement. We suggest that management bias should be included in the matters to be considered in relation to management judgement but not singled out, as it is currently in paragraph 13(b).

- 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?*

As noted above, we suggest that matters listed in the sub-paragraphs as requirements in these paragraphs would be better placed in application material. We have not identified any additional guidance which should be added, but the application material could be reviewed to see where it could be rationalised as there is some overlap in the application material provided for each of the three factors.

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?*

We note that the application material requires referencing in paragraph 20 and vice versa.

We are supportive of the approach in ED-540 of developing a point estimate or range in place of narrowing the range as in the extant standard. However, we suggest greater guidance is required regarding when a point estimate or range is appropriate.

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 does not provide sufficient clarity around evaluation of misstatements and how the auditor’s point estimate or range is used to evaluate management’s point estimate, however the application material does address this issue fairly clearly. The impact of the auditor’s range being many multiples of materiality as discussed in paragraph A134 is not adequately addressed in the application material.

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 support the amendments to ISA 500 regarding external information sources and the clarification between those sources and management experts. In addition, it would be appropriate to reference reports which may be prepared under ISAE 3402 *Assurance Reports on Controls at a Service Organization* and use of those reports under ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* as an alternative source of evidence to the procedures included in first bullet point in paragraph A33F on performing procedures at the external information source.

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.*

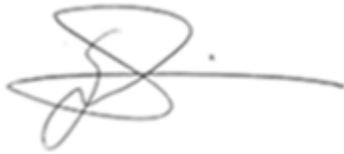
No comment.

- 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.*

We consider that this would be an adequate timeframe for implementation.

If you require further information on our views expressed in this submission, please contact Claire Grayston, Policy Adviser – Audit and Assurance, on +61 3 9606 5183 or at claire.grayston@cpaaustralia.com.au.

Yours sincerely

A handwritten signature in black ink, appearing to be 'Stuart Dignam', with a horizontal line extending to the right.

Stuart Dignam
General Manager, Policy & Corporate Affairs