ICAEW REPRESENTATION 82/17

Proposed International Standard on Auditing 540 (Revised)

ICAEW welcomes the opportunity to comment on the *Proposed International Standard on Auditing 540 (Revised)* published by IAASB on 20 April 2017, a copy of which is available from this link.

This response of 31 July 2017 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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MAJOR POINTS

Support for the project

1. We welcome this ED and congratulate IAASB on its proposals. ED ISA 540 on the audit of estimates is the first in a series of important and far-reaching revisions. The risk ISAs and standards on quality control, group audits and audit evidence are being revised. They all go to the heart of every audit. We also welcome the field testing being conducted through the Global Public Policy Committee and urge IAASB to pay particular attention to the results. IAASB also needs to engage actively in the implementation effort and establish a model with the implementation of ISA 540 that can be used again.

2. An audit regulatory observation made over many years is that auditors deal with estimates inconsistently. There are several reasons for this, some of them firm-related, some driven by regulatory pressure and some relating to ISA 540 itself. The proposals are an attempt to reduce inconsistency and overall, we broadly support the reduction in emphasis on significant risks, the proposed 'stand back', and the enhanced focus on disclosures, models, and bias.

Restructuring is needed

3. We are concerned about the structure of the proposed standard. All of those we consulted believe that while the three risk factors are useful in driving thought processes in performing the analysis, driving the response through three risk factors will result in inconsistency, repetition and inefficiency. We understand that field testing has demonstrated this.

4. Complexity, estimation uncertainty and judgement are tightly interrelated. An estimate by definition includes estimation uncertainty, and estimation uncertainty by definition involves the use of judgement, and any complex estimate therefore involves the other two. Furthermore, they are not, of themselves, risks. They are not 'things that can go wrong'. They are categories that can help auditors think about what might go wrong. The requirement to focus the response on which are the main 'drivers', will result in practice in all three approaches being adopted in many cases, to avoid regulatory challenge. Is this what IAASB really intended? Will it normally be two out of three? Are there any situations in which IAASB can envisage it being one out of three? The distinction between the three approaches described is artificial. The extent of overlap and the interaction with financial statement assertions will result in complex and repetitive matrices analysing risk by line item, risk factor, assertion, assessed risk level and more. The use of the three risk factor model may be useful in the risk analysis process but IAASB should not force its use in driving the response.

5. The PCAOB's proposals on estimates retain an existing recognisable structure while incorporating many of the new elements of IAASB's proposals. This will lead some respondents to suggest that the PCAOB's proposals appear to be more readily workable. Calls for IAASB to *restructure* the proposals should not be dismissed lightly. Restructuring could be achieved in several different ways[1], without altering the substance of the proposals or the need for re-exposure. From a public interest perspective, it must surely be more important than ever that there is as much consistency as possible in the audit of the world's largest banks and other financial institutions and we will be urging the PCAOB to look at what it can do to bring the *substance* of its proposals closer to those of IAASB.

6. ICAEW's Corporate Finance Faculty has recently published its *Consultation paper on prospective financial information* to update *Prospective Financial Information: Guidance for UK Directors,* published in 2003. The proposals would result in updated prospective financial

[1] For example, the proposals could be structured using headings of 'methods, data and assumptions', or 'low risk, not low risk and complex' estimates.

information (PFI) principles comprising, among other things, the three current *preparation principles*, i.e. *reasonable disclosure, business analysis and subsequent validation*:

- *reasonable disclosure* is of uncertainties and mitigating actions;
- *sound business analysis* renders PFI reliable;
- *subsequent validation* renders PFI comparable.

7. We draw IAASB's attention to these principles because the consultation paper proposes to extend the principles beyond the regulated PFI currently in scope, to forward looking information more widely. Forward looking information is now embedded in financial reporting frameworks such as IFRS and many of the challenges faced by auditors auditing, for example, impairments and recoverability are the same as those faced by preparers.

8. Despite an absence of guidance, expectations of both preparers and auditors are high, in terms of the 'accuracy' of the forecasts and projections underpinning many estimates. Banks and others moving to the ECL model are struggling with the transition. It is not easy for any preparer to develop an estimate involving projections 40 years hence, and principles relating to the disclosure of uncertainties, based on a sound knowledge of the business, backed up by subsequent validation where short terms assumptions are projected forward, would be helpful to preparers and their auditors.

9. IAASB cannot resolve this issue but it might acknowledge it in the introductory information to ISA 540. In its engagement with other stakeholders in the financial reporting supply chain, IAASB might also encourage the adoption by accounting standard-setters of guiding principles for the preparation and audit of forward looking information. The three factors developed by IAASB are not shared by preparers and some common ground in this difficult area would be welcomed by both. It would be an unfortunate, if not entirely unpredictable, unintended consequence if auditors were found to approach the audit of estimates by attempting to rationalise or retrofit estimates produced by preparers using IAASB's three factors, for the want of guiding principles. Giving greater prominence to principles of preparation, where they exist, would help align the work of preparers and auditors.

More is needed to achieve scalability, but not all of it in ISA 540

10. Using the inherent risk (IR) assessment as a threshold will be a key issue for some respondents who will question IAASB's approach. The assessment of IR *per se* is not well developed either in these proposals or in other ISAs. ISA 315 on risk assessment mentions in passing the assessment of IR in the context of estimates and other references are limited to a few in ISA 200. We understand the need not to overload ISA 315 but the revision of that ISA needs to be aligned with the revision of this one. The idea that conforming amendments will be made to ISA 540 after ISA 315 has been finalised does not sit well with the nature and extent of these proposals. More is needed somewhere on IR, distinguishing between low and not low IR, IR and the risk of material misstatement and IR and significant risk.

11. We make numerous references in this response to a need for more examples and guidance, and we acknowledge that we are asking a lot. We make no apology for this and have not made these points carelessly. We are asking for a lot because a lot is needed. To ask for these proposals, or any ISA, to serve the largest of financial institutions and the smallest of audits may be asking too much. We do not underestimate the extent of IAASB effort involved in arriving at a position intended to cover both extremes, from the simplest depreciation calculation to the most complex of financial instruments and expected credit losses (ECL), but we believe that more detail is needed at both ends of the scale, not all of it in ISA 540.

12. At the upper end of the scale, auditors of banks, insurers and other financial institutions might be forgiven for thinking that IAASB has lost sight of the original objective of the project, which was to deal with IFRS 9 issues. Our members working in banking and insurance have expressed scepticism as to how the proposals as they stand, will enhance consistency in the

audit of financial institutions. The material on ECL under IFRS 9 and technical provisions under IFRS 17 is thin.

13. We have heard repeated calls for more specific guidance for the audit of banks and insurers, and we therefore strongly suggest that IAASB considers the development of guidance for the application of ISA 540 to the financial sector in the form of an IAPN. This should provide guidance on, among other things, the audit of forward-looking information and approaches to determining when a significant increase in credit risk has occurred. We understand that the Basel Committee is also in favour of an IAPN for this sector.

14. At the other end of the scale, it is difficult to avoid the impression that the proposals are over-engineered in some respects. We sense that while IAASB would like the low IR category to be perceived as the principal means by which scalability has been achieved, this ignores the fact that the financial statements of many SMEs include not low IR estimates.

15. We do not believe that IAASB intends to make extensive changes to the ways firms approach the audit of low IR estimates and IAASB should make this clearer. To the extent that it *does* intend to enhance the approach to such estimates, it should highlight those enhancements. The required *response* to low IR estimates does not appear to represent a significant change from the status quo[2]. However, more work does appear to be required to *assess* the risk associated with such estimates - only in many cases to arrive at the same place as before. Even where it is obvious that the estimate is low IR, all of the paragraph 10 requirements still apply. Explaining this to our members will be a tall order. IAASB needs to do what it can to emphasise the benefits to practitioners and the clients they serve, to prevent a perception arising that the only benefits will accrue to regulators of larger audit firms.

16. The need for implementation material prepared by IAASB for the benefit of smaller firms and the SMEs they serve has never been clearer. Currently, IAASB provides examples of estimates that 'are' low IR, rather than a nuanced discussion. We urge IAASB to consider setting a precedent in this case by developing a staff publication. This should explain and illustrate the practical application of the proposed requirements, enhance the existing examples and provide further examples of estimates that might be considered low IR in some situations and not in others and how, most importantly, auditors might respond to them in practice. This would encourage consistency of application and avoid any perception of rule-making.

17. The behaviour of auditors and regulators is critical, as always, to successful implementation. There is as much of a risk that some auditors will always try to shoehorn estimates into the low IR bucket and ignore the rest of the ISA, as there is a risk that others might seek to avoid that bucket, for exactly the same reason, i.e. a perception that regulators will automatically treat anything in the low IR bucket as suspect. Practitioners from small and large firms alike fear that expectations will arise about which types of estimate fits into which bucket and how big each bucket should be relative to the other. As with the rebuttable presumptions regarding the risks associated with fraud and revenue recognition, and significant and non-significant risks, firms also fear they will waste effort by being driven to treat low IR estimates as if they were not low IR.

18. We are not comfortable with IAASB's proposal to deal with the inconsistency with ISA 700 resulting from the change to the objective for disclosures from 'adequate' to 'reasonable' during the post-implementation review of reporting standards. It is a substantive issue that should be resolved prior to finalisation.

High estimation uncertainty and the 'stand back'

[2] The extant four steps - audit estimate, post balance sheet events, management's process and internal controls - have been rationalised, controls have been taken into management's process and there are now three.

19. IAASB should more clearly address situations in which high levels of estimation uncertainty mean that the range of reasonable estimates may be many times materiality for the entity as a whole - such as for large technical provisions in small insurance companies, and property assets in property investment companies. Currently, there is a brief reference to ranges being multiples of materiality in A134. IAASB might note that in such cases, the size of the provision or property assets should be included in determining materiality for the financial statements as a whole, with a lower level of materiality set for unrelated items. Similar considerations apply to non-bank lenders and life insurers.

20. It is important in cases of high estimation uncertainty to focus on the factors of judgement and complexity. When auditors are genuinely dealing with a high level of true estimation uncertainty, of whatever size, an estimate is not misstated if it is depicted properly using a representative point value that the framework requires. IAASB could make this clearer. It might also make it clearer, without losing framework-neutrality, that most frameworks refer to a representative figure in a range, rather than any number that could be at either end of the range, and that numbers are unlikely to be 'representative' at the outer ranges, particularly if all are equally probable. In cases such as these, the probability weighted estimate would be the mean and not the outer ranges. However, if the distribution were skewed a number further towards an outer range might be a better representation. IAASB might consider giving additional emphasis or prominence to the wording in paragraph A123 referring to management's estimate being 'appropriately representative of the range of reasonably possible outcomes'.

21. We are sympathetic to those respondents who question the legitimacy of asking auditors to 'address' estimation uncertainty if management is unable or unwilling to do so because of the importance of maintaining auditor independence. The term 'address' may be deliberately broad but it may lead to inconsistencies in practice. For example, some may take the view that it is sufficient for management to simply measure and disclose estimation uncertainty, others may believe that management should, where possible, reduce estimation uncertainty to a level below performance materiality.

22. The proposed 'stand back' in paragraph 23 is important. There are few other areas in which ISAs mandate a stand back for such a specific category and this proposal sets something of a precedent. It is therefore important that it is as clear as possible. At present, proposed paragraph 23 does not make it clear whether it relates to individual estimates or estimates collectively. It can be read as applying to either or both. In ISA 330 the response is at the assertion level for an estimate or group or class thereof. This type of ambiguity may satisfy the need to build consensus in the short term but it is a recipe for inconsistency thereafter and we strongly suggest that IAASB resolves it before finalisation.

Costs, benefits and the implementation effort

23. When proposals such as these are made it is often asserted that the best audit teams are already doing much of what is proposed. While this may be true in some cases, documenting it, changing methodologies, training and managing regulatory challenge all represent cost. It is easier to pass costs relating to changes in accounting standards on to clients and we believe that as part of its implementation effort, and for the proposals to stand the best chance of successful implementation, IAASB *must* seek to engage with preparers of financial statements to make them aware or remind them of the:

- changes in the way auditors will be approaching the audit of estimates;
- concomitant need to provide auditors with good quality and internally consistent support for estimates and the related disclosures on a timely basis;
- importance of management taking full responsibility for their own estimates in the financial statements, and to stand back and challenge their own models, data, assumptions and processes, and those of any employed or engaged experts;
- importance of the disclosure of assumptions and sensitivities;

- benefits of better quality audits.

RESPONSES TO SPECIFIC QUESTIONS

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

24. We note above that despite an absence of guiding principles, expectations of both preparers and auditors are high, in terms of the 'accuracy' of the forecasts and projections underpinning many estimates now embedded in financial reporting frameworks such as IFRS. Banks and others moving to the ECL model are struggling with the transition. It is not easy for any preparer to develop an estimate involving projections 40 years hence. Principles of preparation for forward looking information. such as those promulgated by ICAEW's Corporate Finance Faculty, relating to the *disclosure* of uncertainties, based on a sound *knowledge of the business*, backed up by *subsequent validation* where short terms assumptions are projected forward, would be helpful to both preparers and their auditors.

25. IAASB might acknowledge this issue in the introductory information to ISA 540. In its engagement with other stakeholders in the financial reporting supply chain, IAASB might also encourage the adoption by accounting standard-setters of guiding principles for the preparation and audit of forward looking information. The three factors developed by IAASB are not shared by preparers and some common ground in this difficult area would be welcomed by both. It would be an unfortunate, if not entirely unpredictable, unintended consequence if auditors were found to approach the audit of estimates by attempting to rationalise or retrofit figures produced by preparers, using IAASB's three factors, for the want of guiding principles for preparers. Giving greater prominence to principles of preparation, where they exist, would help align the work of preparers and auditors.

26. As they stand, the proposals are weighted towards accounting estimates that are not low IR, but are not the most complex of estimates found in the financial statements of banks, insurers and other financial institutions. There is much more material on not low IR estimates than low IR estimates. Good quality application material and detailed examples are needed to make the proposals workable for both for banks, insurers and other financial institutions, and for the vast majority of audits in which run of the mill estimates are generally assessed as low IR - but not always.

27. For not low IR estimates, IAASB could make it clearer that no extensive changes to the extant approach to the *response* are intended and to highlight the enhancements in respect of the risk assessment. Better quality and more detailed examples are also needed. Currently, IAASB provides examples of estimates that 'are' low IR, rather than a nuanced discussion of different types of risk, the different circumstances in which they might be assessed as low IR or otherwise and, most importantly, how such risks might be dealt with in practice.

28. Implementation material prepared by IAASB for the benefit of smaller firms and the SMEs they serve is needed and we strongly urge IAASB to consider setting a precedent. A staff publication that explains and illustrates the practical application of the proposed requirements and provides further examples of estimates that might be considered low IR in some situations and not in others, and how they might be dealt with in those different situations would encourage consistency of application.

29. At both ends of the scale, observations have been made repeatedly to the effect that had the existing requirements been applied properly, much of what is proposed would have been unnecessary. Revisions to standards are only part of the overall effort to improve audit quality. When finalising this standard, IAASB should call on other stakeholders in the financial reporting supply chain to acknowledge the responsibility of management to provide auditors with adequate support on a timely basis for their accounting estimates when preparing

financial statements, including situations in which valuations are provided by third parties. Engagements should not be accepted or continued if management does not acknowledge its responsibilities for the preparation of the financial statements and while this is sometimes a difficult area in practice, IAASB should resist any suggestion that might dilute, or appear to dilute this important principal. Without auditor independence, there is no audit and auditors cannot eliminate estimation uncertainty by preparing the estimate themselves.

30. IAASB acknowledges that the quality of disclosures relating to estimates is critical and we agree with the upgrade and alignment of the audit objective for disclosures with the objective for estimates themselves. However, auditors will inevitably be unclear as to how the current requirements differ from the previous requirements. The application material has numerous, scattered references to disclosures and there are few cross-references. It would be helpful to consider how these could be drawn together.

The need for an IAPN

31. The original objective of this project was to deal with IFRS 9 issues in the light of G20 concerns about the financial statements of large financial institutions. Our members in that sector have expressed scepticism about how the proposals will, of themselves, enhance consistency in the audit of financial institutions, particularly given the lack of application material on ECL under IFRS 9 and technical provisions under IFRS 17. The example in A5 which refers to the auditors independently estimating ECL on a single loan is grossly over-simplified because it ignores the complexities involved in calculating ECL for an institution whose main business is lending.

32. We strongly suggest that IAASB considers the development of guidance for the application of ISA 540 to the financial sector in the form of an IAPN. This should provide guidance on, among other things, the audit of forward-looking information and approaches to determining when a significant increase in credit risk has occurred. We understand that the Basel Committee is in favour of an IAPN for this sector.

33. Our members in that sector are also rightly concerned about a lack of relevant guidance on internal control within the proposals. This is part of a wider issue about the audit of highly complex estimates. The quality of internal controls, and the control environment in particular, is critical in the audit of such estimates. While sector specific guidance is not appropriate for a general purpose ISA, and we are satisfied that most of the proposed material on internal control is in the application material, these concerns point strongly to the need for an IAPN, developed on a timely basis, for the financial sector.

34. Other examples of areas in which the proposals seem very light, especially in the context of ECL and technical provisions under IFRS 17, include:

- the requirements relating to the ‘stand back’ and bias assessment;
- different types of reporting, including regulatory reporting;
- disclosures.

35. References in A5 to the development of point estimates and ranges for components of estimates such as assumptions and data are confusing. In effect, they amount to developing different assumptions and data against which to benchmark those used by management. What is critical is the impact of those on the actual ECL estimated by management. Similarly, the difference between the 2nd and 4th bullets of A131 is unclear. The former uses management’s model and selects alternative assumptions or data sources to develop a point estimate or range, the latter uses alternative assumptions to those used by management. If the former involves independent inputs to management’s model to assess the actual estimate, this can and should be clearer.

36. We make further more detailed drafting points regarding the audit of ECL below.

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

37. We understand the importance of scepticism relating to estimates because of the risk of management bias, and note that the idea is to drive actions that promote scepticism as set out in paragraph 4. If followed properly, the proposals represent a challenging standard. But the outstanding question for practitioners now, as before, is how much evidence will be considered ‘enough’ by regulators. How far do auditors need to go to show that they have challenged management assumptions effectively, and to what extent do management and auditors need to consider alternative assumptions. Some guidance regarding the nature and extent of the ‘stand back’, and/or examples thereof, is important, particularly in jurisdictions in which a compliance framework is mandated and in which the concept of a ‘stand back’ is not well-embedded.

38. Some query the proposed paragraphs 12 and 14 requirements to determine the need for the use of experts in all cases. The issue is less about the requirement, and more about the need to document a negative, i.e. to make a statement in the vast majority of cases in which an expert is not required. While the increase in the use of fair values in UK and international frameworks has led to increasing reliance on specialists by management and auditors alike, the use of specialists remains the exception rather than the rule. It might be better to deal with this issue in application material in the context of the team discussion, rather than having two separate requirements.

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

39. We sense that while IAASB would like the low IR category to be perceived as the principal means by which scalability has been achieved, this ignores the fact that the financial statements of many SMEs include not low IR estimates.

40. Even a simple loan, not at market rates, can arguably involve complexities and judgements. The accounting regime for smaller entities in the UK, based on the IFRS for SMEs, distinguishes between ‘basic’ and ‘other’ financial instruments and there are fears that regulatory pressure will mean that an estimate will need to be very low IR, or virtually no risk (if such a thing exists) before auditors can safely categorise it as low IR. Some suggest that the trigger should be at the higher end of complexity, judgement and estimation uncertainty to prevent the low IR category becoming redundant and IAASB might consider incorporating some nuance to this effect in the application material.

41. The behaviour of auditors and regulators is critical, as always, to successful implementation. There is as much of a risk that some auditors will always try to shoehorn estimates into the low IR bucket and ignore the rest of the ISA, as there is a risk that others might seek to avoid that bucket, for exactly the same reason, i.e. a perception that regulators will automatically treat anything in the low IR bucket as suspect. Practitioners from firms of all sizes fear that expectations will arise about which types of estimate fits into which bucket and how big each bucket should be relative to the other. As with the rebuttable presumptions regarding the risks associated with fraud and revenue recognition, and significant and non-significant risks, firms also fear they will waste effort by being driven to treat low IR estimates as if they were not low IR.

42. In discussions about low IR estimates, the language used often reverts to ‘complex’ and ‘simple’. We are aware that IAASB considered these terms and rejected them but it might be worth explaining in application, surround or implementation material that while there is considerable crossover between the ‘low IR’ and ‘simple’ or ‘non-complex’ estimates, they are not the same thing.

43. The proposed *response* to low IR estimates does not appear to represent a significant change from the status quo. However, more seems to be required for the assessment of such risks, even where it is obvious that the estimate is low IR, because all of the paragraph 10 requirements still apply. Explaining this approach to our members will be a tall order. IAASB needs to do what it can to emphasise the benefits to practitioners and the clients they serve, to prevent a perception arising that the only benefits will accrue regulators of larger audit firms. Possible ways of doing this include the following:

- making it clear that while many estimates in SME financial statements will fall to be classified as low IR, the increasing use of fair value accounting means that not all estimates in SME financial statements can be assumed to be low IR. IAASB should provide examples of the many industries in which SME financial statements are likely to incorporate several material not low IR estimates, such as those in the print, media and film industries;

- additional discussion of the principles governing the determination of what might constitute a low IR estimate, bearing in mind the potential for the confusion between or conflation of inherent risk, significant risk and business risk.

44. UK regulators note – although it is not widely reported – that auditors often do *too much* in irrelevant areas, sometimes because of this type of confusion. Many firm methodologies, including those marketed commercially and/or provided by training consortia or professional bodies, no longer analyse risk using 'low, medium or high' categories, having moved in line with ISAs some time ago to focus on significant risks. The change in mind set that will be required to implement the shift to low IR estimates and all others, should not be underestimated.

45. We have concerns about the IR assessment generally. A key issue that will lead some respondents to question IAASB's low IR threshold approach is the assessment of IR *per se.* ISA 315 on risk assessment mentions in passing the assessment of IR in the context of estimates but there are very few other references to IR within ISAs, most of them in ISA 200. More is needed somewhere on the nature of IR and its assessment. We understand the need not to overload ISA 315 but the revision of that ISA needs to be aligned with the revision of this one, and the idea that conforming amendments will be made to ISA 540 after ISA 315 has been finalised does not sit well with the nature and extent of these proposals.

46. ISAs currently subsume the IR assessment into the overall risk assessment and the only *discrete* reference to IR is in A39 of ISA 200 which states:

'For example, [inherent risk] may be higher for complex calculations or for accounts consisting of amounts derived from accounting estimates that are subject to significant estimation uncertainty. External circumstances giving rise to business risks may also influence inherent risk.'

47. IAASB might also consider aligning this with paragraph 13 of the proposed ISA by referring in to the fact that management judgement and potential for management bias may also influence inherent risk.

48. More detail should be provided on the examples already given of low IR estimates. For example, depreciation is unlikely to be assessed as a low inherent risk in parts of the public sector. Lists of additional examples are unlikely to be helpful because of the potential for use and misuse thereof by auditors and regulators alike, but what would be helpful is more detail on the existing examples.

49. Performing work on management's process is the most common technique adopted where it is available as an option, in preference to developing an independent estimate or reviewing subsequent events. IAASB should make it clear that auditors should not automatically choose this option simply because it is available, regardless of the quality of management's

process, or because another route, is less straightforward, especially if the alternative route might produce better quality audit evidence. Where appropriate, this would demonstrate the exercise of scepticism and reduce the emphasis on corroborative evidence.

50. Currently, paragraph 10 (f) refers to the need under ISA 315 for auditors to understand the components of controls in relation to estimates. The extensive related application material mostly apples to larger audits and the only reference to the need for auditors to understand controls *relevant to the audit* (which is all ISA 315 actually requires) is in A100 and even then only in the context of 'very small entities'. The absence of reference to controls 'relevant to the audit' in paragraph 10f has the effect of overstating the case. A100 errs on the side of caution in this respect: controls may not be relevant to the audit in audits of any size.

51. Enhancing the application material relating to controls might involve:

- suggesting that auditors consider whether a substantive approach alone is likely to be sufficient for not low IR estimates;
- emphasising the ISA 315 statement that enquiries of management alone are insufficient to obtain an understanding of internal control;
- suggesting that auditors obtain an understanding of the level at which controls operate, and how this is likely to prevent or detect material misstatement.

52. With regard to documentation, the IR assessment takes auditors to ISA 330 for low IR estimates, and leaves the rest in ISA 540. Auditors will need to focus more on *why* the evaluation was made, not on what it was, although they should have been doing this under the extant standard. However, if we are correct in believing that there is no intention to significantly change existing behaviour regarding documentation, and that only the trigger has changed (i.e. the IR assessment, rather than whether something is a significant risk), IAASB could make it clearer than it does that no such change is intended.

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?

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? And

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?

53. We are concerned about the structure of the proposed standard. All of those we consulted believe that while the three risk factors are useful in driving thought processes in performing the analysis, driving the response through three risk factors will inevitably result in inconsistency, repetition and inefficiency. We understand that field testing has demonstrated this.

54. Complexity, estimation uncertainty and judgement are tightly interrelated. An estimate by definition includes estimation uncertainty, and estimation uncertainty by definition involves the use of judgement, and any complex estimate therefore involves the other two. Furthermore, they are not, of themselves, risks. They are not 'things that can go wrong'. They are categories that can help auditors think about what might go wrong. The requirement to focus the response on which of these are the main 'drivers', will result in practice in all three approaches being adopted in many cases, to avoid regulatory challenge. Is this what IAASB really intended? Will it normally be two out of three? Are there any situations in which IAASB

can envisage it being one out of three? The distinction between the three approaches described is artificial. The extent of overlap and the interaction with financial statement assertions will result in complex and repetitive matrices analysing risk by line item, risk factor, assertion, assessed risk level and more. The use of the three risk factor model may be useful in the risk analysis process but IAASB should not force its use in driving the response.

55. The PCAOB's proposals on estimates retain an existing recognisable structure while incorporating many of the new elements of the IAASB's proposals. This will lead some respondents to suggest that the PCAOB's proposals appear to be more readily workable. Calls for IAASB to *restructure* the proposals should not be dismissed lightly. Restructuring could be achieved in several different ways[3], without altering the substance of the proposals or the need for re-exposure. From a public interest perspective, it must surely be more important than ever that there is as much consistency as possible in the audit of the world's largest banks and other financial institutions and we will be urging the PCAOB to look at what it can do to bring the *substance* of its proposals closer to those of the IAASB.

56. It will often be easier to adopt all three approaches. It is difficult to see how intangibles and goodwill impairments, insurance contracts and expected credit losses will ever not involve all three, and revenue recognition, litigation and regulatory sanctions (money laundering, bribery and corruption) are also likely to involve more than one.

57. Can IAASB provide examples of specific instances in which the *only* relevant factor is likely to be estimation uncertainty, judgement or complexity, respectively? If it proves difficult to provide such discrete examples it does beg the question as to whether the distinction is really relevant to the *response*, even if it is relevant to the *assessment.* IAASB should pay particular attention to the results of field-testing in this area.

58. We agree that analysis of the three factors is useful in identifying and assessing the risk, but it is less useful in determining the appropriate response. IAASB should recognise that the three-factor approach to not low IR estimates works as a thought process, but require those three factors to drive the response. Instead, IAASB should include them, or the detailed aspects thereof, in the application material. To the extent that IAASB is making genuine efforts to move towards outcomes-based objectives and requirements in standard-setting generally, this should work.

59. IAASB should also make it clearer that the three approaches to low IR estimates may also be appropriate responses to other estimates. The important point is to perform procedures that are responsive to the risks. The requirements in paragraphs 17-19 are likely to be interpreted as individual audit procedures required to be performed depending on the driver for the estimate. Furthermore, while IAASB makes it clear that complexity, judgement and estimation uncertainty are not the only three factors to be taken into account in the risk assessment, we believe it is unlikely that any alternative or additional factors will be used in practice. We understand that field testing has demonstrated all of this.

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?

60. IAASB should address more clearly situations in which high levels of estimation uncertainty mean that the range of reasonable estimates may be many times materiality for the entity as a whole - such as for large technical provisions in small insurance companies, and property assets in property investment companies. Currently, there is a brief reference to ranges being

[3] For example, the proposals could be structured using headings of 'methods, data and assumptions', or 'low risk, not low risk and complex' estimates.

multiples of materiality in paragraph A134. IAASB might note that in such cases, the size of the provision or property assets should be included in determining materiality for the financial statements as a whole, with a lower level of materiality set for unrelated items. Similar considerations apply to non-bank lenders and life insurers.

61. It is important in cases of high estimation uncertainty to focus on the factors of judgement and complexity. When auditors are genuinely dealing with a high level of true estimation uncertainty, whatever size it is, an estimate is not misstated if it is depicted properly using a representative point value that the framework requires. IAASB could make this clearer. It might also make it clearer, without losing framework-neutrality, that most frameworks refer to a representative figure in a range, rather than any number that could be at either end of the range, and that numbers are unlikely to be 'representative' at the outer ranges, particularly if all are equally probable. In cases such as these, the probability weighted estimate would be the mean and not the outer ranges. However, if the distribution were skewed a number further towards an outer range might be a better representation. IAASB might consider giving additional emphasis or prominence to the wording in A123 referring to management's estimate being 'appropriately representative of the range of reasonably possible outcomes'.

62. IAASB should also acknowledge more fully in application material the dissimilarity between estimation and judgemental differences vis-à-vis factual and known misstatements and the fact that it is not uncommon for one qualified and diligent valuer to arrive at a point estimate for a goodwill impairment or investment that is significantly different to that of another. Application material should therefore suggest that auditors consider the usefulness, or otherwise, of ranges of best estimates and address how auditors should deal with estimates reflecting factual errors within a range of best estimates

63. While we support the proposed requirement for auditors to address estimation uncertainty where management has failed to do so adequately, we reiterate the importance of IAASB engaging with other stakeholders in the financial reporting supply chain to deal with the risk of management failing to address the issue of estimation uncertainty in the knowledge that as a result, auditors will be required to do so. IAASB has a role to play in educating the wider stakeholder group that preparers and users of financial statements also have responsibilities, including understanding that:

- estimates represent a significant element of modern financial statements;
- they are what they say on the tin – just estimates;
- as noted above, it is not uncommon for one valuer to arrive at a point estimate for a goodwill impairment or investment that is significantly different to that of another;
- the solution is often good quality disclosure of the relevant assumptions and sensitivities, regardless of whether they are specifically required by the financial reporting framework.

64. We are sympathetic to those respondents who question the legitimacy of asking auditors to address estimation uncertainty if management is unable or unwilling to do so because of the importance of maintaining auditor independence. The term 'address' may be deliberately broad but it may lead to inconsistencies in practice. For example, some may take the view that it is sufficient for management to simply measure and disclose estimation uncertainty – others may take the view that management should, where possible, reduce estimation uncertainty to a level below performance materiality.

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?

65. The proposed 'stand back' in paragraph 23 is important. There are few other areas in which ISAs mandate a 'stand back' for such a specific category and this sets something of a

precedent. It is therefore important that it is as clear as possible. At present, proposed paragraph 23 does not make it clear whether it relates to individual estimates or estimates collectively. It can be read as applying to either or both. In ISA 330 the response is at the assertion level for an estimate or group or class thereof. This type of ambiguity may satisfy the need to build consensus in the short term but it is a recipe for inconsistency evermore thereafter and we strongly suggest that IAASB resolves it before finalisation.

66. While auditors should form an overall view on the reasonableness of individual estimates, bias may not be evident at the individual estimate level (although it may be for ECL and certain technical provisions). We think that an overall emphasis should be on the ISA 700 'stand back' for the financial statements as a whole, rather than at a collective 'estimates' level. IAASB might also give simple and more complex examples of the use of different assumptions (about growth rates for example) used within the same organisation to support estimates in different areas.

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?

67. We are concerned that the proposals purport to address but skirt around areas in which the availability of independent audit evidence to support certain types of estimate is scarce or non-existent, and the associated difficulties with evaluating the related management processes and internal controls. Such areas include:

- certain types of financial instrument marketed to smaller entities, where there is no market for the instrument and where the only evidence is a single figure provided by the counterparty bank;
- other situations in which the only inputs are at level 3;
- the independent estimate of ECL and some other technical provisions.

68. This lack of evidence gives rise to an increased risk of material misstatement over and above those created by complexity, estimation uncertainty and judgement. Neither the main proposals nor the consequential amendments to ISA 500 on audit evidence regarding external information sources deal with these situations adequately. IAASB should acknowledge more clearly than it does that a limitation in the scope of the audit may, after the auditor has considered estimates both individually and as a whole, be an appropriate response to a lack of sufficient appropriate audit evidence regarding estimation uncertainty. We urge IAASB to address this issue head on when it comes to revise ISA 500 on audit evidence.

69. We understand the additional emphasis on the robust challenge of experts by auditors but IAASB and regulators should recognise that this is an emerging area for SMPs and that even in developed economies, good quality and relevant financial valuation services for SMEs and SMPs are only just beginning to appear. The use of an expert to assist in a valuation should not of itself necessarily result in the assessment of risk as not low.

70. The application material might focus on the importance of expertise when it comes to the integrity of data. The focus is often on the validity of the model. There could also be some discussion of the value of different sources of audit evidence. With regard to liabilities where the counterparty is a bank that sold a financial instrument to an entity, for example, the bank will tend to provide the highest valuation, and expert the lowest, and the auditor's own estimate might be somewhere in the middle. IAASB might acknowledge this, and also the trend for firms to take on more staff with modelling and data skills.

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 the ED-540.

71. We make no comment on this question

(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.

72. Periods ending on or after 15 December 2019 is a year late for expected credit losses but we will, and IAASB should, permit firms to early adopt the standard. IAASB might consider providing examples for financial institutions where there are common issues globally. IAASB might also consider encouraging national standard-setters to provide examples using national GAAP, including examples relating to financial instruments, for example. We understand that the FRC in the UK is considering this.

MORE DETAILED DRAFTING COMMENTS

73. Changes in estimates: the current requirement to determine whether changes in estimates or methods from the prior period are appropriate does not appear to be fully replicated in the ED. 18(a) (ii) deals with the appropriateness of changes in methods, significant data or assumptions, but only where judgement is a factor. This is a critical area in practice and we do not believe that IAASB would want to be perceived as downgrading the extant requirement, especially given the relative lack of emphasis of significant risks which is also open to misinterpretation.

74. The proposed reference to ISA 265 and the auditor's responsibility to report on deficiencies in internal controls in paragraph 26 is useful.

75. A95 states that the ISA does not require an assessment of IR. Paragraph 15 does require this. This appears to be an error.

76. 20A could make it clearer that it is intended to refer to audit evidence already obtained, not new evidence, if that is the case.

77. A35: this should read: 'For example, an accounting estimate may be applied *by* applying a method that uses several data sets and several assumptions'.

78. A62 suggests a retrospective review performed for estimates made over several periods or shorter periods but the related requirement only relates to the previous period. We believe that the requirements should also refer to one or more, or shorter periods, because a more useful history of estimates will emerge over a longer time period.

79. Critical accounting judgements and sources of estimation uncertainty are not distinguished in A112, which is unhelpful as financial reporting frameworks emphasise the difference.

80. The application material dealing with the assessment of differences between management and auditor ranges does not deal with bias in terms of aggressiveness, which is critical in practice.

81. The flowchart supplement illustrating the work effort requirements is helpful. IAASB should consider including it as an appendix to the revised standard.

82. Paragraph 19 in Appendix 1 on measurement bases for fair values ignores the fact that some frameworks define fair value in a different way, such as FRS 102 under UK GAAP which has the old IFRS definition.

83. Appendices 1 and 2 contain useful material relevant to the application of the ISA and should be retained as part of the ISA.

Comments with particular relevance to the audit of ECL

84. The application material on management's point estimate, 9(e), and on 17(a) and (b) on complexity, is limited. Ditto 17(e), 18(a) (iii), 18(c) (i) and (ii).

85. The extent and depth of the required auditor understanding of applicable regulatory factors are not made clear in A15.

86. There is a lack of application material addressing the audit of mid-sized entities. These are critical in the financial sector which has many, including smaller investment businesses and banks, which are nonetheless PIEs.

87. A30 on auditing policy is light in relation to issues such as changes in credit risk, ditto A31 on model validation.

88. A73 is simplistic as a bank does not need to be active internally for ECL to be complex, subject to estimation uncertainty and involve judgement.

89. A76 and A77 are insufficiently granular for the audit of ECL.

90. A86 can be read as implying seems to imply that estimation and judgemental differences are not misstatements, only known and factual ones are. The sentence beginning 'The variation in the measurement of an accounting estimate…' should perhaps state 'The variation in the measurement of an accounting estimate that results from estimation uncertainty is not necessarily, in itself, a misstatement'.

91. Paragraph A104 is light in terms of ensuring that appropriate data is used in a model and assessing the appropriateness of management assumptions.