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Mr Matthew Waldron
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Our ref MC/288

1 August 2017

Dear Mr Waldron

ED: Proposed ISA 540 (Revised), Auditing Accounting Estimates and Related Disclosures

We appreciate the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB) Exposure Draft: Proposed ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* (ED-540). We have consulted with, and this letter represents the views of, the KPMG Network.

The need to change ISA 540

Leading financial reporting frameworks have undergone significant changes in recent years, moving towards a more forward-looking and judgmental accounting for many financial statement items. Consequently, there is an increasing need for management to make accounting estimates and financial statements are subject to greater levels of estimation uncertainty than before. These changes have been accompanied by increasing complexities in the global business environment.

Coupled together, these trends pose significant challenges to both preparers and auditors, as the preparation of accounting estimates often involves the use of numerous subjective and, often inter-related assumptions, complex modelling and increasingly large amounts of data.

These challenges necessitate that ISA 540, and other International Standards on Auditing, be modernised to make them more fit for purpose.

Our overall impressions of ED-540

We agree with the objectives of the project as set out in ED-540 and we appreciate the efforts that have been undertaken to modernise and enhance the requirements of ISA 540. We also recognise the challenge of drafting a standard that is sufficiently scalable, addresses the challenges currently faced by auditors and is future-proof to the extent possible.

Whilst we agree there is the need to update the standard, we have concerns regarding key aspects of the proposals being overly complicated, lacking in clarity and difficult to operationalise. In summary, these concerns relate primarily to the following:

(1) Risk assessment

Risk assessment plays a key role in addressing the challenges described above, enabling the auditor to identify the relevant risk factors that have the most impact on the identification and assessment of the risks of material misstatement, thereby allowing the auditor to develop an audit approach that appropriately responds to those risks.

Whilst we believe there is merit in enhancing risk assessment for the more sophisticated accounting estimates, we believe that ED-540 lacks clarity around some of the requirements pertaining to risk assessment – for example, the extent of these procedures and their interaction with ISA 315;

(2) *The work that the auditor needs to perform to test accounting estimates*

Some regulators have highlighted, for example, deficiencies in:

a. Evaluating the appropriateness (and reliability) of the methods/models used to make accounting estimates;

b. Evaluating the reliability of the data used to make accounting estimates;

c. Evaluating the reasonableness of assumptions used to make accounting estimates, in particular significant assumptions; and

d. Evaluating the design and operating effectiveness of internal control over the methods/models, data and assumptions.

We believe that ED-540 needs to do more to directly address these issues. Specifically, we found that:

— The approach used to make ED-540 scalable (i.e. using a “low inherent risk” threshold) and enhance the auditor’s response by distinguishing between the three risk factors (i.e. complexity, judgment and estimation uncertainty) to be confusing, overly complicated and difficult to operationalise.

  Our initial impression of the approach taken by the PCAOB in its proposed auditing standard on accounting estimates to address scalability and enhance the auditor's response is that it is more intuitive because it is consistent with how management makes the estimate and how audit evidence is available. We encourage the IAASB to consider the merits of this more simplified approach.

— ED-540 appears to be overly complicated for auditing relatively simple estimates;

— There is a lack of clarity around how ED-540 specifically interacts with ISA 330;

— ED-540 could benefit from additional guidance on how to apply its requirements when auditing accounting estimates (either for the simple or more sophisticated estimates). We note that some of the useful practical guidance that exists in extant ISA 540 has not been retained; and

— Further consideration is needed in addressing the challenges related to evaluating the reliability of external information sources.

(3) *Applying professional scepticism and especially identifying and addressing management bias*

This has also been raised by regulators as an area which may not have been appropriately addressed by auditors in the past.

We are generally supportive of the measures taken in ED-540 to address this area, although we have concerns, for example, with respect to the use of three risk factors (i.e. complexity, judgment and estimation uncertainty) and some of the guidance with respect to management bias.

Our detailed comments on ED-540 and possible ways of addressing these comments are described in the Appendix to this letter.

It should be noted that our observations above are consistent with feedback received from our engagement teams involved in the limited-scope field testing of the proposals.

Considering our observations above, we believe that additional work is needed on ED- 540. Our assessment is that ED-540 may not be a significant improvement to extant ISA 540 in addressing the challenges of auditing sophisticated estimates, and we believe it may actually be more complicated to apply in practice for both simple and more sophisticated estimates.

The way forward

We recognise that:

— ISA 540 is intended to apply to all accounting estimates regardless of the assessed risk of material misstatement; and

— The approaches to auditing accounting estimates will generally be consistent for all types of accounting estimates, irrespective of the complexities, judgment and degree of estimation uncertainty involved in making them. Rather, it is the extent of the auditor's work effort and persuasiveness of audit evidence needed that differentiates the audit response, which is driven by the underlying assessment of the risks of material misstatement of the estimate and the rationale for the assessment as it relates to the different components (i.e. data, assumptions and methods/models) of each estimate.

As such, we believe the standard should prescribe the relevant approaches to auditing all accounting estimates (i.e. the approaches identified in ED-540.15(a)), and clearly articulate that, as the assessed risk of material misstatement increases, it is important the auditor responds by identifying and sufficiently understanding the risks related to different components (i.e. data, assumptions and methods/models) of each estimate that impact the assessed risk of material misstatement, and designing an audit approach that appropriately responds to these risks. The application guidance could then expand upon the challenges of auditing the more sophisticated estimates, where it may be more difficult/judgmental to determine whether the auditor has obtained sufficient appropriate audit evidence.

To make the identification, assessment and response to risks of material misstatement more intuitive for the auditor, as well as to be consistent with how the entity makes the estimate and how audit evidence is available, we believe ED-540 needs to describe relevant risk factors for an estimate based on how they relate to the different components of the estimate (i.e. data, assumptions and methods/models), rather than how such relevant risk factors relate to complexity, judgment and estimation uncertainty. Whilst we understand there may be concerns that this proposed approach may result in duplicative guidance in the standard, we believe this could be overcome (see, for example, the proposed approach in the PCAOB's standard).

Furthermore, considering the standard cannot provide detailed application guidance with respect to how the requirements apply to the many varied types of accounting estimates, it may be useful if the standard is complemented by non-authoritative guidance dealing with application of the requirements to more specific sophisticated estimates.

Considering the standard will not be effective for auditing estimates related to the significant new accounting standards (such as IFRS 9 and 15) which become effective on 1 January 2018, our preference would be to allow sufficient time to complete the additional work to ensure that the finalised standard is of high quality, fit for purpose and future proof to the extent possible, even if this means deferring the planned issue and effective date of the standard.

This approach would also have the benefit of allowing the IAASB to:

— Better align ED-540 with the planned revisions to ISA 315, which is currently on the IAASB's work plan;

— Better understand the challenges faced by auditors as they apply extant ISA 540 to the audit of the more sophisticated estimates such as the expected credit loss model, and use these insights to further improve ED-540; and

— Liaise with the PCAOB to achieve more convergence between the proposed standards on auditing accounting estimates, as mentioned above. Our initial review has identified several areas where the proposed approach taken by PCAOB significantly differs from the proposed approach in ED-540 and we do not believe it is in the public interest to have significantly divergent approaches with respect to auditing accounting estimates.

Please contact Matthew Cook at +44 7694 8871 if you wish to discuss any of the matters raised in this letter.

Yours sincerely

KPMG IFRG Limited

KPMG IFRG Limited

cc: Len Jui, KPMG

Appendix – Response to questions included in the exposure draft

Overall Questions

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

As noted in comments on our overall impressions of ED-540, considering the challenges imposed by evolving financial reporting framework and the business environment, we agree with the objectives of the project and we appreciate the efforts that have been undertaken to modernise and enhance the requirements of ISA 540. We also recognise the challenge of drafting a standard that is sufficiently scalable, addresses the challenges currently faced by auditors and is future-proof to the extent possible.

Whilst we agree there is the need to update the standard, we have concerns regarding key aspects of the proposals being overly complicated, lacking in clarity and difficult to operationalise.

Our response to other questions below highlight those concerns and the possible ways of addressing them.

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

We are generally supportive of the steps being taken by the IAASB to reinforce the application of professional scepticism. However, we have concerns regarding the following:

— The use of the three risk factors (i.e. complexity, judgments and estimation uncertainty) – see our response to question 3;

— The requirement in ED-540.19(b) for the auditor to develop an independent estimate when management has not appropriately understood and addressed estimation uncertainty – see our response to question 5. We believe that this requirement may imply that it is the auditor’s responsibility to compensate for management’s ineffectiveness which, in our view, would not be consistent with the concept of maintaining professional scepticism; and

— The guidance with respect to management bias – see below.

Management Bias

ED-540 refers to management bias throughout various phases of the audit:

(1) Risk assessment procedures – understanding how management is identifying and addressing the risk of management bias when preparing accounting estimates and considering the potential for management bias when identifying and assessing the risks of material misstatement (ED-540.10(e)(v) and ED-540.13(b));

(2) Risk response procedures – obtaining evidence about whether management's judgments give rise to indicators of possible management bias (ED- 540.18(a)(i)(b));

(3) Overall evaluation based on the audit procedures performed – considering the need to re-assess the risks of material misstatement due indicators of possible management bias and evaluating the implications for the audit (ED-540.22(a), 24);

(4) Documentation of indicators of possible management bias and the auditor's evaluation thereof in forming an opinion on whether the financial statements as a whole are free from material misstatement (ED-540.27(b)).

We recognise the importance of identifying and appropriately responding to management bias and are supportive of the emphasis being put on the issue of management bias in ED-540. However, we have the following concerns:

a. ED-540 focuses on identifying and addressing all indicators of management bias. We believe it is neither practical nor possible for auditors to identify all indicators of management bias and, as recognised by paragraph ED-540.A148, indicators of possible management bias themselves do not constitute misstatements for the purpose of drawing conclusions on the reasonableness of individual accounting estimates. Consequently, we believe that ED-540 should be clearer that the auditor should focus on identifying and addressing indicators of possible management bias which could result in a material misstatement; and

b. ED-540.18(a)(i)(b) requires the auditor to obtain sufficient appropriate audit evidence about whether management's judgments regarding the selection and use of the methods and the significant data and assumptions give rise to indicators of possible management bias.

   We believe that the auditor should not specifically plan and perform the audit to obtain evidence of the existence of indicators of possible management bias on their own. In our view, the auditor obtains evidence over the data, assumptions and methods that were used to make the estimate, and through evaluating this evidence the auditor considers whether there are any indicators of management bias that may represent a risk of material misstatement. We also believe that if risk assessment procedures indicate a risk of possible management bias that could result in a material misstatement, then the auditor may exercise a heightened professional scepticism to the implications of this potential bias when the auditor obtains evidence over the different components of each estimate.

Furthermore, the auditor may find that obtaining evidence about indicators of possible management bias, as suggested above, is impracticable at the estimate level, considering that ED-540.A7 recognises that management bias may be difficult to detect at an account level and may only be identified when considered in groups of accounting estimates, all accounting estimates in aggregate, or when observed over a number of accounting periods.

Our recommendation is that the IAASB more clearly articulate the auditor's responsibilities in this area.

Finally, we believe the location of ED-540.24 should be reconsidered. In our view, the auditor should consider whether there are indicators of possible management bias before the auditor performs an overall evaluation based on audit procedures performed in ED-540.22-23. This is because, if indicators of possible management bias are identified, the auditor shall evaluate the implications for the audit, including whether the auditor's risk assessment and related responses remain appropriate.

<u>Focus on Risk Assessment and Responses</u>

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

We have a number of concerns with respect to scalability of ED-540, which are outlined below. Our response to this question is divided into several sub-sections:

— Risk assessment procedures and related activities

— Identifying and assessing the risks of material misstatement

— Responses to the assessed risks of material misstatement

3(a) Risk assessment procedures and related activities

Interaction with ISA 315

ED-540.10 requires the auditor to perform risk assessment procedures and related activities to obtain an understanding of certain matters relevant to accounting estimates and related disclosures.

The interaction between these requirements and those outlined in ISA 315 is not clear. ISA 315 is a foundational standard and the requirements in ED-540.10 should clearly build upon (not change or supplement) those in ISA 315. The lack of clear interaction may create the impression of another layer of risk *assessment* and/or may result in certain requirements being interpreted in isolation rather than in combination with related requirements in other ISAs.

Consequently, we believe the interaction needs to be made more clear and explicit.

Our comments below illustrate specific areas where the interaction between ED-540 and ISA 315 may need to be clearer.

Extent of understanding - general

ED-540.A9 elaborates that, in performing the procedures required by ED-540.10, the auditor's primary consideration is whether the understanding obtained is sufficient to:

— Identify and assess the risks of material misstatement; and

— Plan the nature, timing and extent of their further audit procedures.

We believe there could be significant differences in interpretation with respect to the extent of understanding the auditor is required to obtain over accounting estimates.

For example, some of the requirements can only feasibly be applied at the financial statement level (e.g. 10(c) and (d)), whilst others could be more easily applied to the individual accounting estimate (e.g. 10(a) and some of 10(e)). This lack of clarity may result in differing interpretations as to whether ED-540.10 is applied to each accounting estimate or to accounting estimates as a whole. ED-540.A9 and the references to "accounting estimates" in ED-540.10 imply that the auditor is not required to specifically address each requirement for each individual estimate. However, we believe ED-540 should be clarified regarding this matter. Our view is that the auditor should use professional judgment to determine the extent of understanding they need to obtain for the purpose of identifying and assessing the risks of material misstatement, which could vary significantly depending on the nature of the different estimates in the financial statements.

We also note that ISA 315.18(e) requires the auditor to understand the financial reporting process used to prepare the entity's financial statements, including "significant" accounting estimates and disclosures. This appears to be inconsistent with the scope of the requirement in ED-540.10(e). We believe it is necessary to provide further clarification in this area including with respect to the interaction between ISA 315.18(e) and ED-540.10 and the meaning of "significant" accounting estimates.

Extent of understanding - specific considerations for estimates with very little or no estimation uncertainty at the time that the audit is performed

ED-540.9(a) defines an accounting estimate as "a monetary amount…the measurement of which is subject to estimation uncertainty."

ED-540.A75 states that "The auditor's assessment of the risks of material misstatement at the assertion level may be informed by events occurring after the date of the financial statements. For example, the outcome of an accounting estimate may become known during the audit. In such cases, the auditor may assess or revise, when relevant, inherent risk as low, regardless of the extent to which the accounting estimate was subject to, or affected by, complexity, the need for the use of judgment by management or estimation uncertainty at the time management made the estimate."

We believe that when the outcome of an accounting estimate may become known, in certain circumstances, this may enable the auditor to conclude that there is no longer a reasonable possibility of a risk of material misstatement related to estimation uncertainty. It is unclear whether the language in ED-540.A75 is suggesting that an accounting estimate subject to, or affected by, complexity, the need for the use of judgment by management or estimation uncertainty at the time management made the estimate always has a reasonable possibility of risk of material misstatement related to estimation uncertainty, or whether it is simply trying to make the point that, when the outcome of an accounting estimate may be known, it is more likely that inherent risk would be assessed as low and the requirements in ED-540.17-20 would not apply.

Consequently, we believe clarification is needed with respect to the extent of understanding that the auditor needs to obtain with respect to accounting estimates that are expected to be subject to no or very low estimation uncertainty at the time the audit procedures are planned to be performed.

For example, if, when planning the audit, the auditor has a reasonable basis for expecting the outcome from management estimates such as provisions for litigations and claims, purchase accruals or management bonuses to be known when the auditor plans to perform audit procedures, and the auditor expects that this known information will be highly relevant to the estimate made at the measurement date, what would be the extent of understanding required by the auditor?

We believe that if the auditor's assessment is that estimation uncertainty is expected to no longer represent a reasonably possible risk of material misstatement when the procedures are planned to be performed, then the auditor would not need to obtain a detailed understanding of how the accounting estimate had been made. Additional application guidance could clarify that:

— The fact that the outcome of a management estimate is expected to be known when the audit procedures are planned to be performed does not necessarily mean that estimation uncertainty no longer represents a risk of material misstatement. For example, the disposal of a "hard to value" financial instrument measured at fair value several months after the reporting date may provide an indication of fair value at the reporting date, but the auditor would need to consider whether the financial instrument's fair value could have been significantly impacted by changes in market conditions or other factors between the reporting date and the date of disposal. If this was a reasonable possibility, then estimation uncertainty may still represent a risk of material misstatement at the time that the auditor's procedures are performed; and

— When the auditor performs testing, the auditor would need to reassess whether the initial assessment that estimation uncertainty does not represent a reasonably possible risk of material misstatement is still appropriate. For example, if when the auditor starts to perform testing on purchase accruals, and the auditor determines that a significant number of supplier invoices are unexpectedly still outstanding and a number of management's estimates for purchase accruals remain, then the auditor's reassessment of the risk of material misstatement related to estimation uncertainty may lead the auditor to conclude that more work needs to be performed to obtain a better understanding of the risks.

Extent of understanding - internal control

ED-540.10(f) requires the auditor to understand the components of internal control as they relate to making accounting estimates, which includes control activities. We believe clarifications are necessary related to this requirement.

Specifically, the footnote to this requirement references ISA 315.14-24. However, ISA 315.12 makes it clear that the auditor obtains an understanding of control "relevant" to the audit. ISA 315.A100 elaborates that control activities that are relevant to the audit are those that relate to significant risks, those that relate to risks for which substantive procedures alone do not provide sufficient appropriate audit evidence and those that are considered to be relevant in the judgment of the auditor. We believe the application guidance related to 10(f) needs to make it clearer that the requirement to understand control activities is consistent with ISA 315.A100 and therefore that the footnote needs to refer to ISA 315.12-24.

Retrospective Review

Consistent with extant ISA 540, ED-540.11 requires the auditor to review the "outcome" of accounting estimates included in the previous financial statements or their subsequent re-estimation.

Although this requirement has not substantially changed from extant ISA 540, we do not believe there is consistent interpretation of the extent of procedures the auditor needs to obtain to perform to review the "outcome" of accounting estimates. In particular:

— It is difficult to judge the extent of work necessary as it relates to long tail estimates as the outcome may not be known. The new application materials added has not provided sufficient guidance related to these matters. We believe it would be beneficial to provide further application guidance to clarify the work effort related to long tail estimates;

— Paragraph ED-540.A63 states that a retrospective review of management judgments and assumptions related to “significant” accounting estimates (reflected in the prior year financial statements) is required by ISA 240 and that this review may be performed concurrently with the review of the prior period accounting estimates in ED-540.11. We believe it is necessary to provide further clarification application guidance in this area as to whether the retrospective review requirement in ED- 540.11 is required for all estimates or all “significant” accounting estimates. We believe it would also be useful to clarify the meaning of “significant” accounting estimates, which is not currently defined in ISA 315.

Furthermore, with changes to financial reporting frameworks resulting in the emergence of increasingly sophisticated and subjective estimates, such as impairment provisions for loans measured using the expected credit loss model and insurance liabilities, we believe it will become increasingly difficult to apply this requirement.

For example, a provision for impairment losses for loans at a large bank could be made up of individual estimates for each loan portfolio, with each of these estimates relying on multiple models to derive the estimate, and with each model likely having multiple judgments, assumptions and sources of data underlying them. It is unclear without further guidance how much work the auditor would need to undertake to satisfy the retrospective review requirement, particularly when the estimate is made at a point in time and is not affected by subsequent events.

In addition, management of a large bank would likely have a process and internal controls to assist them with identifying the need for a change from the prior period in methods, assumptions or data used in making the estimate. As ED-540.10(e)(vii) requires the auditor to understand how management has addressed the need for a change from the prior period, if the auditor has understood management’s process and believes it is sufficient to enable the auditor to identify and assess risks of material misstatement, then it may be unclear (e.g. when it is a recurring estimate) why the auditor would still be required to perform a retrospective review as an incremental risk assessment procedure.

We believe further consideration should be given to the scope of the retrospective review requirement and that further application guidance should be added to clarify the work effort for the more sophisticated estimates.

3(b) Identifying and assessing the risks of material misstatement

ED-540.13 requires the auditor, in identifying and assessing the risks of material misstatement, to take into account the extent to which the estimate is subject to, or affected by, one or more of the following factors:

— Complexity

— The need for use of judgment by management

— Estimation uncertainty

Distinguishing between these three risk factors is difficult given they are frequently interrelated and relatively broadly defined. Further, as an accounting estimate is defined in ED-540.9(a) as a monetary amount subject to estimation uncertainty, it is not clear how "estimation uncertainty" can be a distinct factor on its own, rather than a result of complexity, a need for judgment or a combination of both.

We also believe that all three risk factors will often be relevant to most accounting estimates, although the magnitude of the impact each factor may have on the estimate could vary significantly. Consequently, it is uncertain how often the auditor could avoid identifying at least two of the three as relevant risk factors. If this turns out to be the case, this could result in work effort that is not scalable to the risks of material misstatement.

We believe the auditor will likely resort to reviewing the objectives related to ED- 540.17-19 in an attempt to determine which risk factors are relevant to the estimate. However, as these more granular matters are organised by the three risk factors, rather than the different components of each estimate (data, assumptions and methods/models), this makes risk identification and assessment less intuitive for the auditor.

Consideration should be given to reducing the complexity of these requirements by instead requiring the auditor to understand different individual components of each estimate to identify and assess the risks of material misstatement (at a level more granular than the three risk factors).

Rather than requiring the auditor to separately consider the three relatively broad risk factors above (complexity, judgment and estimation uncertainty), we recommend more granular risk factors are developed, perhaps derived from the objectives outlined in ED- 540.17-19, and included as example risk factors in the application guidance. Organising these more granular risk factors based on the different components of each estimate (data, assumptions and methods/models) would better align with how management actually makes the accounting estimate and the way audit evidence is available, making risk identification and assessment more intuitive and streamlined.

3(c) Responses to the assessed risks of material misstatement

ED-540 has different requirements for responding to risks of material misstatement at the assertion level depending on whether inherent risk is "low" or "not low" for the purpose of scalability. This approach results in a number of issues:

Consistency with other ISAs

ISA 200.7 requires the auditor to identify and assess risks of material misstatement, which are comprised of inherent risk and control risk. ISA 200.A42 permits the auditor to make a combined assessment (there is no explicit requirement to assess inherent risk and control risk separately). Consequently, the requirement in ED-540.15 to separately assess inherent risk could be problematic for auditors that do not currently do this in practice as permitted by ISA 200. As other ISAs discuss the audit response responding to “higher” or “increased” risks of material misstatement, we believe it would be preferable to use these terms for consistency and because they are better understood.

Secondly, introducing a requirement to assess inherent risk separately for classes of transactions, account balances and disclosures that contain an estimate may raise questions as to whether this assessment is also required for classes of transactions, account balances and disclosures that do not contain an estimate.

Finally, we do not believe ED-540 clearly explains how the terms “inherent risk is low”, “inherent risk is not low” and “significant risk” interrelate. This may cause confusion as to whether inherent risk that is not low is the equivalent of a significant risk or is meant to capture a wider range of risks (we believe “inherent risk is not low” is intended to capture a wider range). We also believe that the approach of distinguishing the work effort between “low” and “not low” inherent risk creates an ambiguity with respect to the interaction between ED-540 and ISA 330 and ISA 500, as described further below.

Examples of low inherent risk

ED-540.A72 provides examples of accounting estimates that the auditor’s assessment of the risks of material misstatement may be based on low inherent risk.

We believe these examples should be reconsidered for the following reasons:

— Depreciation calculations for an entity using a single depreciation method for property and equipment and a relatively low level of additions and disposals.

  We believe that estimation uncertainty for depreciation primarily arises from the selection of an appropriate method to allocate the depreciable amount on a systematic basis over its useful life, the estimate of the useful life and the estimated residual value at the end of the asset’s useful life. The fact that an entity has a single depreciation method and a low level of additions and disposals during a period do not seem to be particularly relevant considerations when identifying and assessing the risk of material misstatement related to estimation uncertainty.

— Accounting estimates that are based on data that is readily available - for example, translation of a cash balance that is held in a currency other than the reporting currency.

  We believe that the inherent lack of precision associated with the measurement of an account balance of this nature would normally be so low that it is highly unlikely that an auditor would identify a reasonably possible risk of material misstatement related to this estimation uncertainty. The suggestion that the estimation uncertainty of a foreign currency denominated cash balance could on its own represent a reasonably possible risk of material misstatement could lead the auditor to conclude that there are almost no accounting estimates for which estimation uncertainty does not represent a reasonably possible risk of material misstatement. It may also suggest that all estimates other than the most simple would have inherent risk that is not low.

Further audit procedures

ED-540.15 has different requirements for further audit procedures depending on whether inherent risk is low or not low. When inherent risk is low, the auditor shall determine whether one or more of three audit procedures would provide sufficient appropriate audit evidence regarding the assessed risks of material misstatement (and perform further audit procedures if needed to obtain sufficient appropriate audit evidence). When inherent risk is not low, the auditor is required to perform further audit procedures to obtain audit evidence about the matters in ED-540.17-20. There are no requirements with respect to the procedures to be performed but ED-540.A97 suggests the three audit procedures in 15(a) may assist the auditor in obtaining audit evidence. There is limited guidance on how to perform these three audit procedures (some guidance in extant ISA 540 has been removed).

This approach results in several issues:

a. It is unclear how certain requirements interact with ISA 330 and ISA 500 and we believe the current wording could cause confusion with respect to the work effort required, particularly when inherent risk is assessed as low. For example, the objectives under ED-540.17-19 could be interpreted as meaning that the auditor only requires sufficient appropriate audit evidence for these objectives when inherent risk is not low. However, when inherent risk is low, we believe the auditor would still need to obtain sufficient appropriate audit evidence with respect to most of these objectives (but the persuasiveness of audit evidence would be less because the risk is lower).

b. When inherent risk is not low, it is not clear whether the auditor is required to obtain sufficient appropriate audit evidence to address the matters under each of paragraphs 17, 18 and 19 if the auditor concludes, for example, that all three factors are relevant but only one or two of the three factors are the drivers of the higher assessed risk of material misstatement. If audit evidence does need to be obtained to address the matters for all relevant factors, regardless of whether they contribute to the higher assessed risk of material misstatement, then considering all three factors will be present in many estimates, it raises the question of what is the purpose of distinguishing between the three factors in the first place.

c. We also find that the objectives under each of the three risk factors are not always intuitive. For example, ED-540.17(a) links whether the significant assumptions are appropriate in the content of the applicable financial reporting framework to complexity. It is not obvious what the link to complexity is in this example.

d. As noted earlier, ED-540.15(b) does not prescribe the audit procedures to be performed when inherent risk is not low. However, several of the objectives for the factors seem to necessitate testing how management made the estimate to obtain audit evidence. For example, if the audit procedures in ED-540.15(a)(i) or (iii) were performed when inherent risk is not low, how would they provide sufficient appropriate audit evidence that management has appropriately understood or interpreted significant data or that management's judgments are appropriate in the context of the applicable financial reporting framework? ED-540.A97 states that the audit procedures performed need to be designed to address the matters in ED- 540.17-19. However, it is difficult to understand how some of these matters could be addressed if the auditor is not testing how management made the estimate. It is not clear whether the intention is to encourage the auditor to test management's process whenever inherent risk is not low, but it does appear that if an alternative audit procedure was performed, top up procedures would then be required to obtain sufficient appropriate audit evidence to meet certain objectives. If the intent is to encourage a preference for testing management's process, consideration should be given as to whether this is appropriate if alternative approaches may provide higher quality audit evidence (such as testing events after the reporting date).

e. Finally, it is unclear whether ED-540.19 has any incremental work effort beyond that required to satisfy the objectives of ED-540.17-18.

Suggested approach

We believe consideration should be given to revising ED-540 as follows:

a. Remove the requirement to differentiate between inherent risk of low and inherent risk of not low for scalability purposes and rather focus on the different components of the estimate (data, assumptions and methods/models) and how the specific relevant risk factors within these components impact the assessment of the risk of material misstatement (which, as noted in our response to 3(b), should be more granular). This would be broadly consistent with the approach taken in the PCAOB's proposed auditing standard on accounting estimates.

b. ED-540.15 already notes that the auditor's further audit procedures shall be responsive to the reasons for the assessment of risk of material misstatement and the higher the assessed risk of material misstatement, the more persuasive the audit evidence needs to be. It would be helpful to build on this requirement by making it clearer that when an estimate has a higher risk of material misstatement, whilst the general approach to auditing the estimate may be the same, the auditor would need to obtain more persuasive evidence to respond to the specific relevant risk factors identified.

c. Remove requirements to obtain sufficient appropriate audit evidence to address the matters in ED-540.17-20 and instead focus requirements on the need to design an audit approach that appropriately responds to the specific risks identified. We believe that the "stand back" requirement in ED-540.22 could provide an extra "line of defence" to ensure that sufficient appropriate audit evidence has been obtained.

d. Expand requirements and application guidance with respect to how the auditor perform the three audit procedures listed in ED-540.15(a) to obtain sufficient appropriate audit evidence.

4. When inherent risk is not low:

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 the proposed requirements are overly complicated and may be confusing for the reasons outlined in our response to question 3 above. Consequently, we do not believe they will support more effective identification and assessment of, and responses to, risks of material misstatement.

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

We recognise the importance of developing requirements that enhance the auditor's ability to identify relevant risk factors that have a significant impact on the identified and assessed risk of material misstatement related to estimation uncertainty and to develop an audit approach that specifically responds to those risks. However, we believe the introduction of the three risk factors above is unlikely to achieve this objective for the reasons outlined in section 3(b) of this letter. Consequently, we are not supportive of the requirements in ED-540.13.

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?

For the reasons outlined in 3(c) of this letter, we believe ED-540 has insufficient requirements and application guidance related to the three audit procedures that would usually be performed to respond to the identified and assessed risks of material misstatement, as described in ED-540.15(a). Our preference would be to remove the requirements to obtain sufficient appropriate audit evidence for these matters, especially given it is unclear how they can be met if the auditor is not testing management's process for making the estimate.

We believe ED-540 should instead focus on requirements that require a response that appropriately responds to the specific risks of material misstatement, and adding additional application guidance on the three audit procedures referred to in ED- 540.15(a) that can be used to test estimates.

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 agree with the approach taken by paragraph 20 to setting the attributes of the auditor's range. We also support the explicit recognition in paragraph A134 that there are circumstances where the auditor's range may be multiples of materiality, as we consider that to be a common issue in practice (e.g. impairment provision for loans using the expected credit loss model, insurance liabilities).

Notwithstanding the above, we have the following concerns with respect to other requirements and application guidance related to the auditor's range:

a. Paragraph 19(b) *requires* (to the extent possible) that the auditor develop an auditor's point estimate or range when management has not appropriately understood and addressed estimation uncertainty.

   This requirement may imply that it is the auditor's responsibility to compensate for management's ineffectiveness. As we do not believe that this was the IAASB's intention, we would encourage the IAASB to emphasise, beyond what is currently mentioned in paragraph A126, that it is management's responsibility to appropriately understand and address estimation uncertainty (an exercise that is required anyway for disclosure purposes in many financial reporting frameworks) and the auditor should focus on management's response.

We also believe that, while the standard recognises that in certain circumstances it may not be possible for the auditor to come up with an independent point estimate or range (e.g. expected credit-loss provision), it does not provide guidance on the auditor's response in those circumstances (i.e. when management has not appropriately addressed estimation uncertainty and the auditor is unable to develop an independent estimate).

Consequently, we believe that the standard should further describe the implications of management not properly addressing estimation uncertainty. For example, such circumstances may have implications on communicating control deficiencies and on the auditor's assessment of the sufficiency and appropriateness of audit evidence obtained.

b. Paragraph A128 states that the auditor's range is considered a substantive analytical procedure. While there may be valid reasons to make such a statement, we believe that it may have some significant unintended consequences. For example:

(1) ISA 520.7 states that if analytical procedures identify fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount, the auditor shall investigate such differences. This seems to suggest a different approach than the one prescribed in paragraph ED-540.A145 of the ED, according to which management's point estimate which lies outside the auditor's range is considered a misstatement without further investigation;

(2) ISA 520.A16 states that the auditor's determination of the amount of difference from the expectation that can be accepted without further investigation is influenced by materiality and the consistency with the desired level of assurance, taking account of the possibility that a misstatement, individually or when aggregated with other misstatements, may cause the financial statements to be materially misstated. This paragraph further suggests that as the assessed risk increases, the amount of difference considered acceptable without investigation decreases in order to achieve the desired level of persuasive evidence. This may seem to convey a different message from the one conveyed in paragraph ED-540.A134 which describes situations where an auditor's range can be multiples of materiality, and therefore could cause confusion.

We further note that it is our understanding that in some jurisdictions a range determined by performing a substantive analytical procedure cannot exceed two times performance materiality. This may cause further confusion regarding the interaction between paragraphs ED-540.A128 and ED-540.A134; and;

(3) When the auditor chooses to develop an independent estimate to audit management's estimate (or a component thereof) which includes a significant risk, the requirement in ISA 330.21 is that the auditor perform additional audit procedures. This implicitly suggests that developing an independent estimate

provides less persuasive audit evidence than the other two approaches to auditing estimates, which we do not believe would necessarily be the case. This may have an unintended consequence that it discourages the auditor from performing this audit procedure when an estimate includes a significant risk.

c. We believe that ED-540 lacks guidance in relation to the work effort that the auditor should perform when developing a point estimate or a range.

   Although the IAASB may have conceptually addressed that by referring to the auditor's independent estimate as a substantive analytical procedure, we believe that ISA 520 contains limited guidance that can assist the auditor in the context of developing an independent expectation for an estimate.

   Coupled with our comment in (b) above, we would suggest that the IAASB remove the reference to substantive analytical procedure and instead incorporate guidance on the extent of work expected from the auditor when developing an independent estimate. We suggest that the IAASB consider the guidance in paragraphs 21-24 of the PCAOB's proposed auditing standard on accounting estimates in this context.

d. It may not be clear whether, and if so – how, the requirement in paragraph ED- 540.19(b) is any different to developing an auditor's point estimate or a range in accordance with ED-540.15(a)(iii). Specifically, it may not be clear whether ED- 540.20 and its related application materials are applicable to an independent estimate made in accordance with paragraph ED-540.15(a)(iii).

   We would suggest clarifying that if the auditor chooses to develop a point estimate or a range (although not required to do so), then the requirements of paragraph 20 and its related application materials are applicable in the same way.

e. ED-540.A133 refers to a scenario where management has developed a range and selected assumptions which lie on the same end of the range – a situation that may indicate management bias. It is not clear why this paragraph is included within the application materials which refer to an auditor's range.

   We would suggest either clarifying the example or relocating it to the application material that discusses management bias.

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 auditors range to evaluate management's point estimate?

We are generally supportive of the requirement in paragraph 23 and its related application material.

We believe that the determination required in paragraph 22(c) – i.e. whether management's decisions relating to the recognition, measurement, presentation and disclosure of these accounting estimates are in accordance with the applicable financial reporting framework – should be part of paragraph 23. This is because this determination relates to the assessment of whether a misstatement exists.

With respect to the auditor's range – see our comment in the response to question 5 above, paragraph b(1).

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?

Whilst we believe the requirements and related application material may result in more appropriate and consistent evaluations of the relevance and reliability of external information sources in certain circumstances, we have specific concerns that the application guidance does not sufficiently address the challenges with respect to evaluating the relevance and reliability of independently obtained pricing information from pricing services and brokers.

The application material in ED-500.A33C-D acknowledges some of the challenges pertaining to the auditor's ability to consider the accuracy and completeness of information for an external information source.

However, we do not believe the application guidance sufficiently addresses these challenges in certain circumstances. For example, the audit procedures in ED- 500.A33F are likely to be difficult to perform when evaluating the reliability of security prices:

a. Performing procedures at the external information source - This is unlikely to be possible for smaller audit firms (due to a lack of a contractual relationship or the information may be considered intellectual property);

b. Testing operating effectiveness of controls management has in place to evaluate reliability - Management of less sophisticated entities are unlikely to have controls in place to evaluate the reliability of security prices from external information sources (other than considering nature and authority of the external information source themselves) for the reasons outlined in a.;

c. Consideration of whether the information is intended to be used in the manner management is using it – If the information is from an external information source rather than a management expert, it could quite likely be subject to disclaimers, caveats or restrictions on use, which may lead the auditor to conclude that the information was not prepared to be used in the manner that management is using it and therefore cannot be relied upon as audit evidence even though it is relevant. However, this does not preclude management from using such data as the caveats are often in place to limit the external provider's liability without undermining the reliability of the data. If information to be used as audit evidence is not available from alternative external information source, it is unclear what the appropriate response would be other than to request management to engage a management expert to prepare a detailed price estimate or to prepare a detailed price estimate themselves; or

d. Obtaining an independent price from an alternative information source – This may be difficult because:

   (i) An alternative source may not be available. In this circumstance, if the other procedures in ED-500.A33F could not be performed either, it is unclear whether the auditor could obtain sufficient audit evidence by performing the procedures in ED-500.A33C alone, or whether they would conclude they have insufficient audit evidence and need to evaluate the impact on the audit;

   (ii) When an alternative information source does exist, this may impose a significant cost on the auditor to obtain the security price, particularly if the auditor needs to obtain prices from multiple sources in order to establish a range;

   (iii) If the auditor obtains a price from one or more alternative external sources, and using that price to estimate the fair value of the securities results in an amount that is not materially different to the estimate made by management, a question arises as to whether this is sufficient appropriate audit evidence that management's source is reliable, given the auditor still does not have a detailed understanding with respect to how either individual security price was determined. If, based on the nature of the estimate, there is likely to be a "reasonable range" that the security price is expected to fall within, and this range has not been reliably quantified but could be reasonably expected to exceed the difference between the sources, can the auditor conclude that the difference between management's source and their own does not need further investigation (as, although the difference may not be material, it may be well above the auditor's threshold for accumulating misstatements)?

   (iv) If the auditor obtains a single alternative price, and using that price to estimate the fair value of the securities results in a materially different amount to the amount recorded by management, it is not clear what the appropriate response would be, particularly given the auditor is unlikely to be able to consider the accuracy and completeness of the information from either management's or the auditor's source. In this circumstance, it would not be possible for the auditor to determine if a material misstatement exists based on the information available. In this scenario, a number of questions arise:

— Would the auditor need to obtain additional security prices from other sources to try and develop a range?

— If there were no alternative external information sources, would the auditor conclude that they do not have sufficient audit evidence that management's source is reliable, and request management either to prepare their own detailed price estimate or to engage a management expert to prepare it and then test this estimate to obtain audit evidence?

— If the auditor considers the nature and authority of management's external information source to be comparable to the auditor's source, what is the appropriate response when the difference between the two sources cannot be easily understood and is material or more than trivial? If, based on the nature of the estimate, there is likely to be a "reasonable range" for the security price, and this range has not been reliably quantified but could be reasonably expected to exceed the difference between the sources, can the auditor conclude that management's source is reliable without further investigation of the difference?

— If the auditor can accept management's external information source without fully understanding the reasons for a material (or more than trivial) difference between that source and the auditor's, this raises the question of the purpose of obtaining an alternative security price in the first place (particularly if the auditor has assessed that management had used the "best" source available and that the alternative source is known to be less reliable).

As demonstrated by the scenario discussed above, further consideration of the challenges related to evaluating the reliability of security prices provided by pricing services and brokers, along with additional application guidance, appears to be needed. The PCAOB, in its proposed auditing standard on accounting estimates, has developed more extensive guidance on responding to the challenges in this area. This may be useful to consider if further application guidance is developed.

Finally, we note that the current wording in ED-500.A33H appears to suggest that, when management and the auditor have used the same source and there is more than one source available, the auditor may be expected to obtain information from an alternative external information source. We believe this wording should be clarified to make it clear that this is a matter of the auditor's professional judgment, which will in part depend on the nature and authority of the source and the circumstances (ED-500.A33C).

Request for General Comments

8. In addition to the request 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.

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 the 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 understand the need to promptly address the evolution of financial reporting frameworks, such as IFRS, in a way that will provide auditors with tools to tackle the new challenges.

Considering the standard would not apply to auditing the estimates related to the significant new accounting standards (such as IFRS 9 and 15), which become effective on 1 January 2018, we do not believe there is an urgent need to mandate a short period of time between the issuance of the standard and the time it becomes effective. Major revisions to ISA 540, as currently planned, will require significant time to at least:

— Study the requirements;

— Identify any changes to current practice, including with respect to broader implications than those related to estimates (such as inherent risk assessment);

— Agree on appropriate interpretation of the standard;

— Incorporate the new guidance into firm's manuals and tools; and

— Provide training to firm's personnel.

As these processes take time, we believe that the period of 18 months suggested in the question is the minimum time that should be provided from the moment the standard is issued and until the standard becomes effective. Notwithstanding that, early adoption should be permitted and encouraged.

Other Matters

Written Representations

In accordance with the proposed ED-540.25, "the auditor shall obtain written representations from management and, where appropriate, those charged with governance that they believe the methods, significant data and significant assumptions used in making the accounting estimates and their related disclosures are appropriate to achieve recognition, measurement or disclosure that is reasonable in the context of the applicable financial reporting framework".

We have the following concerns regarding the requirement in paragraph 25:

a. The required representation uses terms that may not be defined under the applicable financial reporting framework (and if defined – they may be defined differently than the ED) and may not be well understood by management (e.g. the meaning of "significant data" or "significant assumptions", as defined in ED-540.A35, or the meaning of the terms "reasonable" and "appropriate" as defined in ED-540.A2-A3);

b. It is not clear why the auditor would be satisfied with representations about only the significant data and assumptions rather than all data and assumptions, and why data and assumptions would be referred to differently from methods in this respect; and

c. The representation does not relate to the reasonableness of the estimate as a whole. It may be the case, for example, that while assumptions are reasonable on their own, they may be inconsistent with each other or result in estimates that are not reasonable.

Consequently, we would recommend that the representation obtained relate to the reasonableness of the accounting estimates, including the appropriateness of underlying methods, assumptions and data, in the context of the applicable financial reporting framework.

Appendices

With respect to Appendix 1, *Measurement Bases of Accounting Estimates,* we recommend the IAASB consider removing this content from the standard. The guidance appears to be primarily accounting related, educational in nature, and it is unclear how it interacts with, or complements, the requirements and guidance in the standard itself, which could cause confusion.