IAASB
Attn. Prof. Arnold Schilder, Chairman
529 Fifth Avenue, 6th Floor
New York, New York 10017
USA

Date	Re	Our ref	Attachment	Direct dial nr
August 1, 2017	ED ISA 540	KvH	-	020-3010399

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

Dear Mr. Schilder,

The NBA appreciates the opportunity to comment on the Exposure Draft *International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures* (hereafter the 'ED'). First we will give some general comments before answering your questions.

General Comments

We support the effort of the IAASB to revise ISA 540. Estimates are increasingly relevant in financial statements and therefore an updated standard is needed. An example of the increasing relevance is the implementation of IFRS 9. We therefore understand the need to move quickly in the public interest. At the same time we encourage the IAASB to take the time needed to make sure that the standard is not only technically sound but that it is also easy to understand.

This standard should change auditor behavior for the audit of small entities and large entities. We would encourage the IAASB to take an extra three months to finalize the standard if the IAASB felt that that time would improve understandability of the standard for large firms and for SMP's. It is Royal NBA's experience that Mark Twain's words "*I didn't have time to write a short letter, so I wrote a long one instead"* also applies to ourselves as standard setters and that it is not only relevant with regards to the length of our publications but also with regards to the clearness of the publications.

<u>Three factors</u>
We welcome the idea that different factors drive the work load in the standard. We wonder whether the right factors (complexity, judgment and estimation uncertainty) are chosen. In the ED, the existence of estimation uncertainty is a precondition for an estimate and it is also one of the three chosen factors. To us this is confusing.

We recommend using the following three factors:

1.	Access to data and assumptions for the estimate	Focusing on reliability and availability of data and assumptions
2	Subjectivity of the estimate	Focusing on necessary judgement and possible management bias
3	Complexity of calculation of the estimate	Focusing on need to use models, difficult calculations and to deploy specialists.

In our opinion these three factors drive estimation uncertainty for an accounting estimate, clearer differentiate between each other and it will be easier to define audit procedures than the three factors mentioned in the ED (see response to Q4b).

<u>Low inherent risk/threshold</u>
We support the thought that for an estimate with 'low' inherent risk it is not necessary to perform the same level of work as for an estimate with higher inherent risk. Thus we support the threshold approach. We suspect that from a conceptual perspective low estimation uncertainty (as defined above), will probably lead to low inherent risk. Nevertheless the standard does not make clear to us how to distinguish between low inherent risk and other levels of inherent risk. Therefore it is not clear to us when the 'threshold'-approach can be taken (limited procedures when inherent risk is low).

According to the definition of inherent risk, the determination of inherent risk should not be influenced by internal control Therefore, although sometimes helpful, it is conceptually not always necessary to understand the internal control environment to determine the level of inherent risk. Especially for simple estimates in simple environments it might not be useful and not worthwhile to get an understanding of the control environment. We suggest that the standard recognizes that as soon as the auditor has enough evidence to determine that inherent risk is low there is no need to deepen his understanding of the internal control environment (see response to Q3).

<u>Work effort</u>
The workload for the three factors in the ED is 'output driven' ('objective-based'). No concrete audit procedures are specified, instead the audit evidence to be obtained is described. In general we support this approach, but we recognize that this is new and challenging to auditors. Applying this approach includes applying professional judgement and professional skepticism. Therefore different auditors might come to different conclusions what is sufficient appropriate audit evidence. In the public interest we feel that it is necessary to provide as much guidance as necessary to ascertain that auditors perform the necessary procedrues. Although we already worry about the extensiveness of application material we strongly believe that it is necessary to provide detailed examples of possible procedures (see response to Q4a).

<u>Models</u>
The ED explains that it might be necessary for the auditor to develop an own model when management's model is not appropriate. Although we understand that it might be necessary for an auditor to develop an own model to evaluate management's point estimate , this introduces several risks:

- Developing an own model might endanger the independence of the auditor. Therefore guidance should be provided to avoid that the auditor takes over management responsibilities. Therefore management should provide a representation that they agree to the model of the auditor and take responsibility for the estimate, based on the model.
- When the auditor develops an own model, the data and assumptions used do not need to represent the data and assumptions used by management. This might become an issue when management provides disclosures about the estimate in the financial statements based on his own evaluation. Therefore the auditor should make sure that the disclosures are in line with his own model.

(see response Q4c).

Range

If the auditor defines a range he should only accept values that are supported by the audit evidence and are reasonable according to the auditor. We have problems understanding how the range of the auditor's estimate should be determined. For instance when the auditor concludes that for an actuarial calculation an interest rate should be used between 3 and 4%, are all values in between than acceptable? We recommend giving clear guidance and examples (see response Q5).

Structure and content

The ED is very extensive, primarily in the application material. Especially the paragraphs about risk assessment and internal control are very comprehensive. This does not help the user to easily understand the standard. This is a pity given the fact that the flow chart that was provided shows shows clearly the simplicity of the process described in the ISA. We therefore strongly suggest to at least add the flow chart as an appendix to the standard. In addition we have the following suggestions to improve the accessibility to the ISA:

- The ISA includes in the application material educational material, that explains for instance on what a model is (A26 – A29), which might be helpful to certain auditors whilst others are aware of this information. We wonder if as a general principal for this and other ISA's application material that is educational should not be moved to appendices. Real application material should focus on applying the requirements not on educating the auditor on more broader issues. In our opinion this would improve the accessibility of this ISA and the ISA's in general.
- With regards to applying ISA 315 the ED provides 4 requirements and 85 paragraphs of application material. We feel that a lot of this material could be integrated in ISA 315. We fully accept that ISA 315 is a separate project and that it is too early to update ISA 315 with the material in ISA 540. At the same time we wonder whether it wouldn't be a better solution to create a temporary solution (for instance ISA 315 A) thus creating a clean ISA 540.
- We suggest to use more plain English and easier constructs. For instance paragraph 8(the objective) states:

> *The objective of the auditor is to obtain sufficient appropriate audit evidence about whether:*
>
> *(a) Accounting estimates, <u>whether recognized or disclosed in the financial statements</u>; and*
> *(b) Related disclosures in the financial statements,*
>
> *are reasonable in the context of the applicable financial reporting framework.*

We do not understand why we need the underlined text. Paragraph A2 provides an abridged version of the objective without this construct.

- Paragraph A2: The first sentence repeats paragraph 8 and could therefore be removed. We do not understand where the other considerations come from, especially the second bullet. The second bullet could be moved upwards to the "normal" considerations.
- Paragraph A71 is a repetition of paragraph 13 and can therefore be removed.
- References between the paragraphs in the application material make the ED also complex. We recommend limiting this as much as possible.
- Appendix I is very theoretical and explains the techniques. We recommend considering to make this more practical and explain how the auditor should deal with the various measurement bases.

If helpful we can share some further detailed comments with the task force.

Request for Comments

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

The ED 540 sufficiently reflects the developments in financial reporting frameworks. Forward looking information is taken into account by describing models and assumptions. There is extensive attention to models in the ED and in our opinion part of the application material can be considered as educational material. Given the fact that according to the IESBA Code of Ethics the auditor is required to act with professional competence and due care we wonder whether some of this educational material might be considered as knowledge that the auditor should have upfront when auditing certain types of entities such as financial institutions. We wonder whether the ISA's are the right place to educate the auditor. Although reporting frameworks are getting more complex, it would be helpful if the ISA's focused on auditing their requirements.
We recommend shortening the educational material about models and/or removing them to an appendix. This would focus the application material on how the auditor should apply the requirements of the standard. For example, the explanation of paragraph 10, which ranges from paragraph A9 up to A60 could (partly) be moved to an appendix.

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

Although attention is paid to professional skepticism, we feel that the standard could provide more examples to demonstrate how professional scepticism can be applied. For instance we suggest to add more guidance on how to deal with contradictory audit evidence. More guidance could also be given as to whether, how and to what extent management's estimates should be challenged.

At the same time the standard should be clear that the auditor cannot reduce inherent estimation uncertainty by performing more audit procedures and applying professional skepticism.

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

The term 'scalability' might mean different things to different auditors / stakeholders and it is not entirely clear which one is meant here. The focus regarding the scalability of estimates is on estimates with a low inherent risk. In terms of SMEs, the ED is therefore not necessarily scalable (and we wonder whether it should be). That depends upon whether SMEs have low inherent risks regarding estimation uncertainty. Although SME's in general are less complex compared to for instance listed entities, for certain estimates of SMEs inherent risk will not be low.

At the same time given the fact that the work load with regards to the factors is evidence driven we suppose that there is a second level of scalability. Sufficient appropriate evidence regarding (one of) the factors in case of high inherent risk might be more extensive then when inherent risk is moderate. The standard could demonstrate this in examples in the application material. In many cases SMEs could benefit from this.

Although a few paragraphs are dedicated to SME's, this could be more extensive. For example, in paragraph A23 it is not clear which information should be obtained from the owner-manager and how to determine whether this is sufficient.

In terms of work effort, the ED can be considered scalable if inherent risk is low ('threshold'). However to clearly identify in practice whether inherent risk is low is difficult. The standard nor the ISAs in general do not provide guidance on how to decide whether inherent risk is low.
Furthermore, we wonder whether internal controls need to be considered (paragraph 10f) if inherent risk is low and whether paragraph 16 can apply if paragraph 15a has been applied

(low inherent risk). Internal control is not relevant to determine whether inherent risk is low. Paragraphs 10f suggests that internal control should be considered although inherent risk is low. This both would not eliminate the work effort. In some situations substantive testing would be sufficient. Therefore we suggest to move the paragraphs about internal control after paragraph 15a the 'threshold', or made conditional in situations where inherent risk is already evaluated as being low, and clearly explained that they might not be applicable when inherent risk is low.

Finally, we suggest to make it clear which audit procedures should be performed in paragraphs 17-20 when inherent risk is not low and when there is insufficient internal control.

Q4a 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?

According to us the standard is not clear how the fact that inherent risk is higher than low relates to significant risks. According to the standards a significant risk is a risk that, in the auditor's judgement, requires special audit consideration. Given the fact that this standard provides specific requirements for estimates that have an inherent risk that is higher than low, taking in account Paragraph 28e of ISA 315, we wonder whether this by definition is not a significant risk. We wonder whether this is intended and therefore encourage the IAASB to provide more clarity what is intended with the concept of 'special audit consideration'

If inherent risk is not low, but risk of material misstatement is low, would this lead to the right work effort?

As mentioned in the general remarks we are of the opinion that parts of ED 540 should be transferred to ISA 315 as they relate to risk assessment (e.g. paragraph 28 of ISA 315.

Furthermore, the ED is 'output driven' ('objectives-based'). No concrete audit procedures are specified, only the audit evidence to be obtained. Although we understand that this approach has been chosen, we doubt whether this is clear for auditors in practice. We recommend giving concrete examples of audit procedures to be performed in certain situations.

Further less attention could be paid to using specialized skills or knowledge. Reference could be made to ISA 620.

Q4b Do you support the requirement in ED-540 (Revised) for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors, including complexity, the need for the use of judgment by management and the potential for management bias, and estimation uncertainty?

We do support the factor approach, however we do not support the specific three factors mentioned. There is overlap in the three factors and management bias is a factor included in judgment but also mentioned separately. The definition relates to estimation uncertainty only and not to the other two factors. Estimation uncertainty is a precondition for an estimate and estimation uncertainty is often caused by the other two factors. This seems to be mixed up in the ED. However, the work effort relates to the three factors. We question whether it is clear in practice which audit procedures should be performed to respond to the risks and whether the three factors really can be separated in the work effort.

We recommend reconsidering the three factors by taking the following three factors into account:

1.	Access to data and assumptions for the estimate	Focusing on reliability and availability of data and assumptions
2	Subjectivity of the estimate	Focusing on necessary judgement and possible management bias
3	Complexity of calculation of the estimate	Focusing on need to use models, difficult calculations and to deploy specialists.

In our opinion these three factors determine estimation uncertainty and will be easier to audit than the three factors mentioned in the ED.

Q4c Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?

We question whether it is clear when an auditor should develop his own point estimate or range and whether this is appropriate. This could result in a disproportionately high work effort for the auditor and an unwanted situation where the auditor performs the work that management should do. We recommend to give more guidance in the following areas: should the auditor build his own model when the model of management is not appropriate or does this go too far and can this only be done as last resort? Developing an own model might endanger the independence of the auditor. Is it appropriate to disapprove the model of the management? How should this be disclosed as this might be sensitive to disclose and will this have an effect on the auditor's opinion? (see also Q5)

If inherent risk is low, the auditor should also consider developing a point estimate or range to evaluate management's point estimate. This is not further explained. Is this realistic if inherent risk is low? We recommend to give more guidance in this area.

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?

With the new approach the range is already "narrowed down" because there needs to be audit evidence and amounts in the range have to be "reasonable" (which is not defined). Furthermore, at this stage, materiality does not have to be taken into account (two-step approach). This seems realistic. However, we wonder whether it is clear how the auditor should develop a point estimate or range. We recommend to give clear guidance how to determine whether the point estimate or range is reasonable by providing concrete examples. For example, if an actuarial calculation is used and the range of the expected life of men varies from 82 till 85 years. Are all outcomes between 82 and 85 appropriate or not?

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?

We assume that this will be the case.
Is it made clear how to deal with big differences between the management's point estimate and the auditor's point estimate or range. In paragraph A144 is stated that this does not necessarily has to be a misstatement. However, if there are big differences, the auditor should reconsider the audit evidence.
In paragraph A145 is stated that the difference between the management's point estimate and the nearest point of the auditor's range is the misstatement. Isn't this contradictory?

The relationship between materiality and estimation uncertainty is not fully explained. We recommend to develop more guidance in this area.

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?

We support the new term and application material although the application material is very elaborate. However, we wonder whether the information should be limited to publicly available information; it should not be specifically be prepared for the entity (this is the distinguishing criterion), We recommend reconsidering the definition. We also recommend to give guidance how the reliability of the external information source should be considered for example, when Bloomberg information is used. Is this type of information considered to be reliable in general or should this be demonstrated and if so, how should this be done?

Q8a 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.

We reiterate our general remark that long, complex sentences are difficult to translate. We recommend using shorter sentences. Furthermore, several terms such as ‘level 1 inputs’ might be difficult to translate.

Q8b Effective Date—Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.

We consider a period of 18 months for implementation after approval of the final ISA a reasonable period. We support earlier implementation as IFRS 9 will be applicable earlier and audit firms might want to implement the final ISA as soon as possible.

Closing Remarks

For further information, please contact Jan Thijs Drupsteen

Yours sincerely,

Royal NBA, the Netherlands Institute of Chartered Accountants,

Signed by
Anton Dieleman
Chair of the Dutch Assurance and Ethics
Standards Board