

Professor Arnold Schilder
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International Auditing and Assurance Standards Board
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1 August 2017

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

Dear Professor Schilder

On behalf of RSM International Limited, a worldwide network of independent audit, tax and consulting firms, we are pleased to comment on the IAASB's Exposure Draft, Proposed International Standard on Auditing 540 (Revised) - Auditing Accounting Estimates and Related Disclosures.

Overall, we support the IAASB's proposals in the Exposure Draft as they would strengthen the quality of audit procedures for addressing the risks of material misstatement associated with accounting estimates. We also find the IAASB's proposals to be responsive to calls heard from regulatory bodies and other stakeholders to strengthen the auditing standards in this context. However, our view is that the IAASB should be open to considering the structure and organisation proposed by the PCAOB for the revision of its own auditing standard for auditing accounting estimates. Further, we encourage the IAASB and PCAOB to continue dialogue to minimise differences in these standards by combining the strengths and robustness of the IAASB proposals with the structure and organisation of the PCAOB standard.

In addition, we have a number of concerns relating to the practical aspects involved in the assessment of inherent risk and the related audit response. These are set out in more detail in our comments on Question 4a below.

Our comments and detailed responses to the questions set out in the Request for Comments in the Exposure Draft are detailed hereafter.

We would be pleased to respond to any questions the Board or its staff may have about any of our comments.

Please do not hesitate to contact us via Steve Witcher at +44 207 601 1831.

Yours sincerely,

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Overall Questions

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

In overall terms, we believe that ED540 has been appropriately updated, particularly in the light of IFRS 9.

Our view is that the requirements and application paragraphs are generally clear and useful, although there is the danger that some auditors adopt a checklist approach to the guidance and try to address every paragraph. To mitigate this issue, but being mindful of the danger that some auditors may copy the ISA without regard to the particular circumstances of their client, some practical examples of risk assessment and response in different situations might be helpful.

In addition, a draft flowchart summarising ED540 was provided to attendees at the Forum of Firms meeting in London in May. Once the standard is finalised, an updated flowchart as an appendix would help auditors to see the bigger picture in the new ISA.

However, we have a few concerns regarding risk assessment and the related response as set out below under Q4.

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

Yes, we believe they do encourage the application of professional scepticism despite our reservations over the risk assessment process which we discuss below under Q4.

In particular, we welcome the clear focus on assessing risk and developing appropriate responses coupled with a requirement to “stand back” in paragraph 22. Auditors can be prone to focussing on individual audit procedures and not seeing the bigger picture. Paragraph 22 should, if properly performed, help to address this issue.

Focus on Risk Assessment and Responses

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

Yes, we consider that ED540 is sufficiently scalable and we generally support one ISA to deal with the wide range of estimates. The focus on inherent risk by considering complexity, judgment and estimation uncertainty will assist in this because smaller entities may well have only the less complex accounting estimates to deal with. However, we have some conceptual reservations about the way in which this assessment has been implemented as set out in Q4 below.

Paragraph 10 is particularly useful in directing auditors to the risk assessment requirements however the length of the standard may add to a perceived problem regarding scalability for smaller entities. In particular, paragraph 10e seems to assume that all entities have robust procedures for making each individual accounting estimate. At best, smaller entities may only have these procedures at entity level and in many cases they will be undocumented and informal.

4) When inherent risk is not low (see paragraphs 13, 15 and 17–20):

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

Overall, we support the concept of assessing risk and responding accordingly as outlined in ED540. It is consistent with ISA 315 and ISA 330. However, we have the following concerns with the way in which this approach is outlined in ED540:

- The way in which risks are categorised seems to be a departure from the assessment of risks in ISA 315 where risks that are not considered significant in accordance with paragraph 27 are not then described as "low".
- Notwithstanding the concept of a significant risk and the required responses thereto, ISAs generally recognise a spectrum of risk to encourage auditors to design responses appropriate to the specific risk itself rather than its categorisation. ED540 appears to categorise risks as "low" (paragraph 15(a)), "not low" (paragraph 15(b)) and "significant" (paragraph 13) but the responses to the latter two categories appear to be the same, whereas ISA 330 requires greater audit effort for significant risks. In addition, some methodologies may not have a concept of "low" and therefore this label may cause some confusion.
- In order to address the issue of "low" inherent risk and to bring ED540 into line with ISA 315's approach to the assessment of inherent risk, we suggest the following approach:
 - The auditor should perform risk assessment over estimates in line with paragraphs 10-13
 - For all estimates, the auditor should perform the procedures in paragraph 15
 - The auditor should then assess whether they have sufficient appropriate audit evidence over the estimate, or whether further procedures are necessary. This is a matter of professional judgment that depends on:
 - Whether the estimate is a significant risk; and
 - The extent to which the estimate involves complexity, judgment, or estimation uncertainty, and these risks are not adequately addressed by the procedures in paragraph 15.
 - If further procedures are required, the auditor would perform the procedures from paragraphs 17-19 as appropriate.
- Some of the drafting in paragraph 15 could be improved. For example,
 - The requirement to obtain audit evidence about subsequent events in paragraph 15 (a)(i) should also make clear that some of these could be assessed as non-adjusting under many reporting frameworks.
 - Audit procedures designed to address paragraph 15(a) would often include some of the responses set out in paragraphs 17-19 but paragraph 15(b) could be read to imply that, for "low" inherent risks, those paragraphs can be ignored. However, even for a "low" risk, the auditor might want to understand whether the method is appropriate (per paragraph 17(a)) and whether the calculations are mathematically accurate (paragraph 17(e)). Arguably these are included in paragraph 15(a)(ii) but it is a little ambiguous.
 - Consistent with the principles of ISA 315, clear reference is made to assessing the risk of material misstatement at the assertion level and we expect that this would often relate to the valuation/allocation/accuracy/presentation assertions. However, we see the possibility that auditors may assess the risk at the account balance level, albeit that this is not what ED540 requires. The risk is that all assertions might then be assessed as "not low" and unnecessary audit procedures would be performed on assertions which should have been assessed as "low". It could be more explicitly stated, or possibly guidance added, that auditors can assess some assertions as "low" despite the complexity, judgment and estimation uncertainty affecting the accounting estimate.
- It could be more explicitly stated in paragraph 15(b) that the matters in paragraphs 17-20 rank equally in the assessment of the inherent risk of an accounting estimate.
- We suggest that paragraph 18(a)(ii) is amended to include reference to methods, data or assumptions that should have changed but did not.
- The definition of "significant" data and assumptions could be improved beyond that contained in paragraph A35 by clarifying which measurement of materiality is being referred to.
- Clarification on the extent of documentation on each of the three factors in paragraphs 17-19 would be useful. For example, is it required to document the assessment of each of the three elements or is it left to each auditor's judgment? The latter seems to be the case but more explicit clarification would help auditors.

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?

Overall, we support the requirement for the auditor to take into account the relevant factors and they are well explained in the standard, although some clarifications would be useful as described elsewhere in this response.

However, it could be argued that complexity and judgment are sub-sets of estimation uncertainty.

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?

Yes, we believe that the guidance is generally comprehensive, however, we consider that there may be an issue with the apparent binary nature of paragraphs 17-19, particularly in the light of paragraph 15(b)'s statement "when applicable".

For example, an estimate might be assessed as "not-low" due to complexity but not judgment or estimation uncertainty. However, one or both of judgment or uncertainty might be present but not as the overriding consideration in assessing the risk of material misstatement. The current drafting implies that the impact of these other two factors could be ignored in the design of further audit procedures.

This seems illogical and may not be the Board's intention. We recommend that paragraph A97 be amended to make the Board's intention on this point clear.

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?

Yes, we believe that this will be more effective than the current approach in ISA 540 as this has often been hard to achieve and document adequately in practice. We also welcome the removal of the requirement in paragraph 15(a) of extant ISA 540 to assess how management have considered alternative assumptions or outcomes for significant risks. Sometimes management did not carry out this exercise, particularly in smaller entities.

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

We particularly like the "stand back" requirements in paragraphs 22 and 23. Professional firms often try to encourage their audit teams to stand back from the detailed work and consider the audit evidence as a body of work. These requirements should therefore result in a better overall assessment of whether the accounting estimate is reasonable and hence more consistency.

We consider that a more explicit requirement to consider ISA 705 in situations where the auditor is unable to obtain sufficient appropriate audit evidence should be included after paragraph 23.

In addition, we consider that paragraph 24 could be amended so that it is clear that it includes both intentional and unintentional bias.

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?

Yes, we consider that the proposed amendments to ISA 500 and the related application paragraphs will improve the consistency of the evaluations of the relevance and reliability of information from external information sources.

We believe that the auditor's assessment of the reliability of external information sources is important in gathering sufficient appropriate audit evidence about the accounting estimates made by management rather than auditors simply assuming that third party sources are reliable without subjecting them to any form of evaluation or testing.

However, this proposal as currently drafted would apply to all audit evidence whereas we understand that the intention is to improve the rigour around auditing information used in accounting estimates. We therefore see a risk that the proposed amendments to ISA 500 restrict the ability of auditors to exercise judgment in determining the extent of testing of the reliability of data used in various other areas of an audit. We suggest that either the additional drafting in ISA 500 is more clearly linked to the audit of accounting estimates or that, preferably, the drafting is included in ISA 540.

Request for General Comments

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

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

We have no further comment on this point.

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

We have no issue with the effective date. The 18 month period should provide auditors with sufficient time to amend their methodologies to take account of the new ISA 540.

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