IBRACON
INSTITUTO DOS AUDITORES INDEPENDENTES DO BRASIL

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International Auditing and Assurance Standards Board (IAASB)
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear All,

We, the IBRACON – Instituto dos Auditores Independentes do Brasil (Institute of Independent Auditors of Brazil), appreciate and thank you for the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB) Exposure Draft ISA 540 (Revised) *Auditing Accounting Estimates and Related Disclosures* (ED-540).

Leading financial reporting frameworks have undergone significant changes in recent years, moving towards a more forward-looking and judgmental accounting for many financial statements items, which involves an increasing use of accounting estimates. Consequently, we believe it is appropriate for the IAASB to consider how International Standard on Auditing (ISA) 540 should be revised to reflect the evolving nature of financial reporting standards that address accounting estimates, as well as the auditing challenges that arise therefrom. We support the IAASB's initiative to prioritize the enhancements of ISA 540 to be responsive to, in particular, the impending effective date of IFRS 9 - Financial Instruments, which presents heightened challenges to both management and auditors as it relates to the preparation and auditing, respectively, of estimates related to expected credit losses. Nevertheless, some of the same auditing challenges identified in respect of IFRS 9 exist in practice today for other complex accounting estimates, to varying degrees, including across industries. Therefore, we support the IAASB's approach to enhance ISA 540 for the audit of all accounting estimates, not just those related to IFRS 9 or the audit of financial institutions.

Our recommendations and proposed changes are listed below.

Please contact us if you wish to discuss the contents of this letter.

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 our view, the proposed changes address important concepts to financial reporting frameworks, including focus on data, assumptions and disclosures. However, we have concerns regarding key aspects of ED-540, such as the integration of proposed risk factors into the risk assessment framework and the design of the audit response outlined in questions 3 and 4, being overly complicated, lacking in clarity or difficult to operationalize. In this way, we believe further guidance could be provided in this ED, starting from the auditor's risk assessment procedures, on the importance of the auditor giving explicit consideration to whether management's process to make the accounting estimate represents the appropriate requirements of the applicable financial reporting framework.

The need for the use of judgement and estimation uncertainty are useful considerations when thinking about the susceptibility of the estimate to error or fraud. However, we believe the way in which the factors have been incorporated into the standard does not result in an effective approach to identifying and assessing the risks of material misstatement at the assertion level, and, consequently, to responding to those risks.

The proposed amendment to ISA 540 to address external information sources and the importance of assessing the relevance and reliability of information obtained from sources outside of the entity also helps in focusing attention on new sources of data and information related to financial reporting frameworks.

It is also critical to consider expectations of users, including regulators, about what is needed to comply with those financial reporting requirements, in particular disclosures.

We believe the proposed additions to the requirements included in the ED, specifically the greater granularity of the matters about which the auditor is required to obtain audit evidence are an improvement in guidance on the matter. This is important to show which evidence is sufficient to demonstrate that the auditor has appropriately challenged managements' assumption or what evidence is required regarding external information received from third party sources.

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

We support the increased emphasis on professional skepticism in ED-540. Evaluating the relevance, reliability and sufficiency of evidence and providing robust challenge to management in areas of subjective judgement are critical elements in auditing accounting estimates. We believe that the revised requirements in the proposed ISA, which includes an enhanced and granular risk assessment process, will encourage a more detailed understanding of how accounting estimates are determined by management and also will focus the auditor to think more about the reasons for the assessment given to risks of material misstatement and where audit procedures need to be targeted to obtain sufficient appropriate audit evidence.

We suggest adding further guidance on the documentation that would be sufficient to demonstrate the auditor's responsibilities in this area and that the auditor appropriately challenged management's assumptions and the extent to which alternatives were considered.

Additionally, we suggest take into account the IAASB's Professional Skepticism Working Group point of view prior the issuance of the revised ISA 540, to ensure that appropriate terminology to address the auditor's work efforts related to professional skepticism is being used in ED-540.

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

We believe that the ED-540 is a good start in addressing scalability. Scalability is, in our view, best addressed by establishing principles-based standards and allowing auditors to apply them by tailoring to the circumstances and facts of each audit, modifying the nature, timing and extent of procedures to be responsive to the assessment of risk.

However, we have some concerns related to the requirement to assess inherent risk as low or not low. We do not believe that introducing a threshold of "low inherent risk" would be appropriate. Paragraph 15(a), in exempting low inherent risk ("less complex") estimates from the detailed requirements in paragraphs 17-19, may appear to create a perception, of "less work". The approach set out in paragraph 15 (a) should be available to any estimate, not only for those with a low inherent risk.

Removing the low risk threshold will, in our view, also eliminate the very significant potential for subjective disagreements between auditors and audit inspection bodies as to the auditor's determination of whether a risk is, or is not, subject to "low inherent risk".

We also believe that a more prominent focus on testing events subsequent to the balance sheet date, when those provide sufficient appropriate audit evidence, alone, would boost the perception of scalability. We suggest that the application material should better illustrate scalability in responding to assessed risks.

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?

Generally, we support many of the concepts and related guidance that have been incorporated in the proposed ED. We believe that these requirements will promote a more granular consideration of the nature and extent of what could go wrong, to inform the auditor's risk assessment at the assertion level and design appropriate responses. That includes the need for judgement and how estimation uncertainty can influence the assessment of identified risks (e.g., whether the risk of misstatement at the assertion level is low, or higher, or a significant risk) and how best to design further audit procedures to obtain evidence in response to the risk.

Despite our agreement with the approach taken in ED-540 for significant risks, we believe further clarification is necessary to explain how the more granular work effort in ED-540 relates to the requirement in ISA 330.21 to perform procedures specifically responsive to significant risks. When the auditor designs responsive procedures (that appropriately include tests of details when required by ISA 330.21) to achieve the objective-based requirements of paragraphs 17-20 of ED-540, is the requirement in ISA 330.21 also fulfilled? If not, what other considerations should the auditor be taking into account to develop procedures specifically responsive to the significant risk? Additionally, we believe the proposed requirements are overly complex and may be confusing for the reasons outlined in question 3 above.

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

We continue to believe that identifying and evaluating the risk of material misstatement for account balances, classes of transactions, and disclosures <u>at the assertion level</u> remains appropriate. The assertions identified in ISA 315 (e.g., existence, completeness, accuracy and valuation etc.) are the ways in which an account balance can be misstated. Complexity, judgment and estimation uncertainty are useful considerations to think about “what could go wrong”. They can influence the assessment of identified risks, but they are not the risks themselves.

For this reason, we suggest that paragraph 13 be enhanced to incorporate the requirements of paragraph 15, and the related response to assessed risks (paragraphs 17-19) not be driven by factor. We also suggest reinforcing the focus on the impact, and interplay, of the three factors in identifying and assessing RoMM.

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?

No. We believe it is important to maintain a strong consistency with the requirements of ISA 315 and ISA 330. There is a risk that the multitude of concepts being incorporated into proposed ISA 540, including the risk factors and “matters” about which the auditor needs to obtain evidence, could cause confusion as to what the auditor is responding to.

We recommend that the understandability and practical application of the ISA can be enhanced by:

(i) Positioning the proposed risk factors of complexity, the need for the use of judgement and estimation uncertainty as useful considerations when thinking about the susceptibility of the estimate to error or fraud, or “where things can go wrong”: They can help inform the auditor’s identification and assessment of the risks of material misstatement at the assertion level, but should not be the basis for that assessment and response. * This is consistent with how risk factors are used in ISA 240.

(ii) Adopting a more intuitive structure for the response to assessed risks that better reflects the way in which audits of accounting estimates are actually approached.

(iii) Giving greater prominence to testing events subsequent to the balance sheet date. In most cases, since this approach is capable of providing sufficient appropriate audit evidence, it would be the most appropriate approach.

(iv) Creating a more explicit requirement and related guidance that addresses expectations of the auditor when developing their own point estimate or range. For example, if the auditor uses management’s method or model, data or assumptions.

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 support the intent of paragraph 20.

We also support the explicit recognition in paragraph A134 that there are circumstances where the auditor’s range may be multiples of materiality. In some cases, the estimation uncertainty associated with certain accounting estimates is such that the range of reasonably possible outcomes is very broad and may exceed materiality. However, the auditor cannot simply audit away in those circumstances. He should also focus on audit of inputs of the accounting estimates (i.e. considering the relevance and the reliability of the information, data or assumptions to be used as audit evidence in accordance with ISA 500). Additionally, we emphasize the importance of transparent disclosure about the estimation uncertainty in the explanatory notes of financial statements.

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With respect to item 20 (a), questions arose as to the specific intent of the phrase “are supported by the audit evidence”. There was uncertainty as to whether the reasonableness of the range was to be assessed based on audit evidence obtained from the procedures performed or if this requirement was implying that there was a need to obtain some further additional level of evidence. We propose adding guidance and explanatory material to clarify if discrete audit evidence will be needed.

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 support the application material in paragraphs A142-A146. When the auditor develops a range that includes reasonably possible outcomes supported by the audit evidence and management’s point estimate falls outside of that range, the misstatement cannot be anything other than the difference between management’s point estimate and the nearest point on the auditor's range.

Similarly, when management’s point estimate does fall within the auditor’s range then we agree that there is no misstatement. It is important that the auditor understands how management selected their point estimate and, taking into consideration the audit evidence obtained, whether such selection is consistent with the audit evidence. Any indicator of bias or selection of an amount inconsistent with audit evidence obtained or decisions taken with respect to other accounting estimates should be challenged. We therefore support the related application material (A147-A152) addressing potential bias.

With respect to paragraph 23, it is unclear whether the requirement sets an expectation of determining that each accounting estimate is reasonable or misstated, as opposed to “the accounting estimates and related disclosures” collectively. The language used is leading to confusion as is the positioning of the requirement relative to paragraph 22, which clearly and explicitly states applies to “each” accounting estimate (that is subject to paragraphs 17-19).

Additionally, we understand that it is important to clarify when the auditor concludes an accounting estimate is not reasonable, a misstatement exists. This clarifying will help in a more consistent determination of misstatement, especially when is needed to evaluate management’s point estimate.

Conforming and Consequential Amendments

7) With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?

We do not believe that the amendments of ISA 500 will achieve the intended objective of the auditor more appropriately and consistently evaluating the relevance and reliability of external information sources (“EIS”).

In practice, given the broad range of external information sources that exist, further guidance may be needed on the nature and extent of the auditor’s work effort in satisfying this requirement, particularly in situations where the availability of evidence may be limited given the source of the information.

However, we believe there could be a stronger and more explicit link in ISA 540, specifically the response to risks, to the proposed new content in ISA 500. While paragraphs A82 and A83 highlight the potential risks relating to external information sources (and could also reference ISA 500), there is no equivalent material in the risk response section. A short application paragraph to accompany each of the requirements addressing assumptions and data, drawing this important link, seems appropriate.

There are also likely to be challenges in making the determination/distinction between an external information source and a management’s expert depending on the nature of the information being provided to the entity. Therefore, we welcome the examples provided in application material.

With respect to the definition of external information source, we caution that the reference to "publicly available" is at risk of being misunderstood, notwithstanding application paragraph A1, and risks inadvertently narrowing the intended scope of the definition. We suggest deleting the words "publicly available" from the definition and using the application material to explain that the information is available to a "broad range of users upon request".

The new application paragraphs A33 focus on management using of the EIS. We believe that the auditor uses of the EIS needs to be clarified, because the lack of this information can cause confusion and inconsistency in evaluating information from an EIS that management has not used and the auditor uses as audit evidence.

Additionally, we want to stress out that in some markets can be difficulty to obtain external reliable sources of information.

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 believe that it is important to eliminate redundancies and repetitive phrases to make the translation effort easier and to avoid that the intention of the requirements and the related application material are lost in the translation.

(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 understand the need to promptly address the evolution of financial reporting frameworks, however, considering the current timetable and the need to perform more work on ED-540 before it is finalized we would not expect it to become effective prior to December 31, 2019 audits. Therefore, we believe the IAASB should consider an effective date that allows sufficient time for implementation.

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