International Organization of Securities Commissions
Organisation internationale des commissions de valeurs
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21 August 2017

Technical Director
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, 10017 U.S.A.

Our Ref: 2017/IAASB

Subject: International Auditing and Assurance Standards Board ('the Board') Exposure Draft, Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures ('ED')

Dear Sir,

The International Organization of Securities Commissions' Committee on Issuer Accounting, Audit and Disclosure (Committee 1) appreciates the opportunity to comment on the ED. As an international organization of securities regulators representing the public interest, IOSCO is committed to enhancing the integrity of international markets through the promotion of high quality accounting, auditing and professional standards, and other pronouncements and statements.

Members of Committee 1 seek to further IOSCO's mission through thoughtful consideration of accounting, disclosure and auditing concerns, and pursuit of improved global financial reporting. Unless otherwise noted, the comments we have provided herein reflect a general consensus among the members of Committee 1. Our comments are not intended to include all of the comments that might be provided by individual securities regulator members on behalf of their respective jurisdictions.

Overall Comments

We support the Board's efforts to improve the requirements and guidance for auditors in auditing accounting estimates and related disclosures.

In this letter, we have identified instances where we believe the final standard could be improved. We are disappointed that the ED does not address key issues with the extant standard and that the testing objectives required to be met are unclear.

We believe it is important that the matters outlined in this letter are addressed in the final standard. However, if the Board decides to proceed with a standard without dealing with the key matters that are outlined in the following three sections of this letter, we believe the

Board should give priority to follow up projects to address the matters we discuss later in this letter under the following subheadings:

- "Sampling, identification of differences to investigate and evaluate errors";
- "Use of the auditor's own experts"; and
- "Specific guidance on financial instrument valuation and related areas".

We believe it is important that, as a minimum, all other matters outlined in this letter should be addressed in the final standard.

Responses to the assessed risks of material misstatement

Paragraphs 14-20 under the heading "*Responses to the Assessed Risks of Material Misstatement*" require different testing objectives to be applied based on the assessed level of inherent risk. When inherent risk is assessed as 'low', the auditor response is required to follow paragraph 15(a). When inherent risk is assessed as 'not low', paragraph 15(b) directs the auditor to meet the testing objectives in paragraphs 17-20, when applicable.

Contrary to the approach in the ED, we believe that a single set of testing objectives should apply in all cases irrespective of the assessment of risk or the classification of risk by complexity, judgement and estimation uncertainty. Instead, the nature, timing and extent of the procedures required to be designed and performed by the auditor should differ based on the risk assessment as 'low' or 'not low' and the reasons for that assessment. See our comments below related to the designation of 'low' or 'not low'.

Even if the Board were to retain its current approach, and we do not support this, the Board should consider whether paragraphs 14-20 may be overly complex, unclear, and consequently could result in inconsistent application by auditors.

Application of testing objectives in paragraphs 15 and 17-20

As stated above, we believe that the testing objectives in paragraphs 17-20 of the ED should apply to both situations where inherent risk is assessed as 'not low' and where inherent risk is assessed as 'low'. For example, the appropriateness of the valuation method and assumptions, the relevance and reliability of significant data, and the accuracy of calculations (see paragraph 17) all appear to be applicable matters whether inherent risk is assessed as 'low' or 'not low.' The assessed risk should only affect the nature, timing and extent of the procedures to be applied by the auditor, not the testing objectives.

The testing objectives in paragraphs 15 and 17-20 should be included in a single list that applies irrespective of the assessed inherent risk. This may necessitate reviewing the testing objectives and, for example, removing duplication and addressing overlap.

'Low' vs. 'Not Low' Inherent Risk Assessment

While paragraph 13(n)(i) of ISA 200 defines the term 'inherent risk', which is further discussed in paragraph 7 of ISA 330, paragraph A40 of ISA 200 states that the ISAs do not ordinarily refer to inherent risk and control risk separately. Instead, inherent risk is a component of the auditor's assessment of the risk of material misstatement. While it may be a matter for the ISA 315 project, we believe that the auditor should be required to consider and assess inherent risk and control risk separately.

The significant focus in the ED on inherent risk assessment, including determination of further audit procedures based on the auditor's conclusions about the inherent risk, is a new approach under ISAs for requiring auditor responses to risk. This, combined with the fact that the concepts of 'low' and 'not low' inherent risk are new and not clearly defined and explained in the ED, could lead to inconsistent audit approaches.

Responding to Inherent Risk that is 'Low'

When responding to inherent risk that is 'low', paragraph 15(a) requires the auditor to evaluate whether one or more of the following three further audit procedures would provide sufficient appropriate audit evidence:

- Obtaining audit evidence about events occurring up to the date of the auditor's report;
- Testing how management made the accounting estimate and the data on which it is based; or
- Developing a point estimate or range based on available audit evidence to evaluate management's point estimate.

These three further audit procedures appear to be largely consistent with the approaches to auditing accounting estimates outlined in paragraph 13 of the extant ISA 540. However, we are concerned about the lack of more detailed requirements or guidance on these three further audit procedures in the ED. In particular, the ED does not retain the application guidance in paragraphs A59–A95 of the extant ISA 540. As a result, it may not be sufficiently clear what procedures the auditor is required to perform to achieve the objectives outlined in paragraph 15(a) of the ED, which could result in an inconsistent, and potentially inappropriate, audit execution. For example, it is not clear whether the auditor is required to evaluate if significant assumptions made by management in developing an accounting estimate are reasonable in each of the further audit procedures listed in paragraph 15(a). The Board should consider clarifying the requirements for the three further audit procedures as well as provide further guidance to auditors regarding execution of these procedures.

Responding to Inherent Risk that is 'Not Low'

The Board should consider the issues outlined in this section if the Board continues its current approach, which we do not support, of allocating testing objectives based on the assessment of inherent risk as 'low' or 'not low' and classifying risks based on 'complexity', 'judgement' and 'estimation uncertainty'.

Definitions of 'low' and 'not low' risk

Furthermore, the lack of definitions of 'low' and 'not low' risk, combined with the significant difference between the nature and extent of the further audit procedures required to achieve the objectives of paragraphs 15(a) and 15(b), might create an incentive for some auditors to inappropriately assess the inherent risk as 'low' to avoid the burdens of the requirements in paragraphs 17-20 while claiming the protection of 'professional judgment' for their risk assessment conclusions.

Is the approach in paragraph 15(a) available?

It is not clear from the ED whether the auditing procedures outlined in paragraph 15(a) would also be available to auditors when responding to inherent risk that is 'not low'. We are concerned about limiting the auditor's ability to select the most effective audit approach. There might be situations, even when inherent risk is assessed as 'not low', that one of the approaches listed in paragraph 15(a), or a combination thereof, might be more effective in obtaining sufficient appropriate audit evidence regarding an accounting estimate, for example when the outcome of the estimate is known based on an event or transaction that occurred prior to the date of the auditor's report. If, however, it is not the Board's intent to restrict the procedures the auditor can perform to comply with the requirements in paragraphs 17-20, this should be made clear.

Risks that relate to 'complexity,' 'judgement' and 'estimation uncertainty'

Paragraphs 17 to 19 of the ED would require the auditor to determine which of 'complexity', 'judgement' or 'estimation uncertainty' give rise to inherent risk being assessed as 'not low' and then only satisfy the testing objectives under the relevant category. However, we believe that the three concepts are often not sufficiently separable to guide an effective audit response. For example, estimation uncertainty is by definition (paragraph 9(a)) a key characteristic of any accounting estimate. Furthermore, estimation uncertainty is often a function of a complex model used in the estimation process that may also require significant judgment from management. As such, it would appear that many (if not all) of the testing objectives in paragraphs 17-20 would represent relevant considerations for most (if not all)

accounting estimates, including accounting estimates with a 'low' assessed inherent risk. However, the ED separates them into three distinct categories.

The following examples illustrate the lack of clarity as to why certain testing objectives were considered relevant to one but not the other reasons for the auditor's risk assessment. In most of these examples we illustrate one area in which the objective may also apply but, as discussed above, we believe these objectives would apply to most (if not all) estimates, including estimates with a low assessed inherent risk:

- It is not clear why some level of data testing, as required by paragraphs 17(b) to 17(d), would not be a relevant consideration for virtually all accounting estimates that use data especially when testing how management made the accounting estimate (while we acknowledge that paragraph 18(a) directs the auditor to evaluate whether *management's judgements* regarding the selection and use of the method and the significant data and assumptions are appropriate, the ED only appears to require such direct testing of data for estimates associated with inherent risk that is 'not low' based on the estimates' complexity);
- It is unclear why the requirement for the auditor to obtain sufficient appropriate audit evidence about whether management has appropriately understood or interpreted significant data when the reason for the inherent risk assessment of 'not low' includes complexity (paragraph 17(c)) would not also apply where judgement by management is the factor that gave rise to the inherent risk assessment as 'not low';
- It is not clear why the testing objectives related to judgements on complex modelling when the reason for the inherent risk assessment of 'not low' includes judgment (paragraph 18(c)) would not also be applicable when 'complexity' was the factor that gave rise to the inherent risk assessment;
- It is not clear whether paragraph 18(a)(iii) should also include significant data and not just significant assumptions when assessing the consistency of information used in accounting estimates and other areas of the entity's business activities;
- It is not clear why it would not be appropriate for the auditor to develop his or her own point estimate or range in certain circumstances when assessing whether management's point estimate is reasonable where estimation uncertainty (paragraph 19(a)(ii)) or complex methods (paragraph 17) are the factors that gave rise to the auditor's inherent risk assessment as 'not low'. The auditor may decide to develop his or her own point estimate or range to challenge management's estimate. In the ED, the development of the auditor's point estimate or range seems to only apply

when management has not appropriately understood and addressed the estimation uncertainty (paragraph 19(b)) or where inherent risk is low (paragraph 15(a)(iii)).

Furthermore, we are concerned with any inference that in instances where management has not appropriately understood or addressed the estimation uncertainty of an accounting estimate, this can be overcome by the auditor's response. The auditing standards should not imply that the auditor's responses could abdicate management of their financial reporting responsibilities; and

- It is not clear why the need to consider whether adjustments to the output of the model are consistent with the reporting framework applies only under the 'judgement' concept (paragraph 18(c)(iii)) and would not also apply to estimates where the reasons for the inherent risk assessment of 'not low' include 'complexity' or 'estimation uncertainty'.

As a result of the difficulty to distinguish among 'complexity,' 'judgment' and 'estimation uncertainty', there is a risk that auditors may default to responding only to some of the reasons for the assessment given to the risk of material misstatement. In those circumstances, due to the segregated nature of the testing objectives in paragraphs 17-20, auditors might omit certain testing objectives that, while not associated with the key drivers of the auditors' risk assessment, are still important to the ultimate audit conclusion.

Alternatively, given the difficulty in distinguishing between the concepts of 'complexity', 'judgement' and 'estimation uncertainty', auditors may default to addressing all the testing objectives in paragraphs 17-20. In that case, they may be confused by the seemingly overlapping nature of some testing objectives. For example, both paragraphs 17(a) and 18(a) require auditors to evaluate certain aspects of the appropriateness of management's selection of the methods, significant data and assumptions used in the estimation process.

Given the objective based nature of the requirements in paragraphs 17-20 and the potential overlap among the concepts of 'complexity,' 'judgment' and 'estimation uncertainty' and their related testing objectives, the Board should consider whether all (or a subset of) the testing objectives in paragraphs 17-20 should be required to be met for all accounting estimates, irrespective of the reason for the assessment of their inherent risk as 'low' or 'not low' risk, and whether or not the auditor places reliance on controls. Under such an approach, auditors would respond to the assessed risks of material misstatement by varying the nature, timing, and extent of the further audit procedures performed in response to the defined testing objectives.

While we would not support the approach in the ED of only applying the testing objectives based on which of 'complexity', 'judgement' and 'estimation uncertainty' gives rise to an

assessment that inherent risk is 'not low', if the revised ISA 540 adopts that approach, the following should be made clear:

(a) Whether the testing objectives under 'estimation uncertainty' should always apply regardless of whether inherent risk is assessed as 'low' or 'not low' and the reasons for that assessment; and

(b) The distinction between the concepts of 'complexity', 'judgement' and 'estimation uncertainty'.

Risks that do not relate to 'complexity', 'judgement' or 'estimation uncertainty'

The testing objectives in the ED described in paragraphs 17-20 apply where risk is assessed as 'not low'. These testing objectives are limited to situations in which the reasons for the assessment given to the risk of material misstatement include either complexity (paragraph 17), judgment (paragraph 18), or estimation uncertainty (paragraphs 19-20). It is not clear, and the Board should clarify, what procedures an auditor should perform when the inherent risk of an accounting estimate is assessed as 'not low' but for reasons other than complexity, judgment, or estimation uncertainty. It appears the standard allows for other reasons with the use of "including" when discussing the relevant factors considered in the auditor's risk assessment in paragraph 13.

Objective based requirements

The "Explanatory Memorandum to ED-540" explains that the requirements in paragraphs 17-20 are not drafted in the form of procedures that shall all be performed, or a list of possible procedures from which the auditor should choose. Instead, these paragraphs contain requirements that are focused on objectives ("testing objectives") that the procedures selected by the auditor need to accomplish.

We are concerned that the lack of specificity as to the nature and extent of the further audit procedures that the auditor should perform, or consider performing, in connection with paragraphs 17-20 might lead to inconsistent audit approaches and an inability of regulators to enforce high-quality audits. Therefore, we ask the Board to consider providing further requirements for the audit procedures that the auditor should perform, or consider performing, to achieve the testing objectives in paragraphs 17-20.

Sampling, identification of differences to investigate and evaluating errors

We are concerned that the ED does not address key methodology issues in testing estimates such as values of financial instruments. We believe that the Board should give priority to a further project to develop additional guidance in this area. While some of these issues might be also relevant to a project on data analytics, they should not be delayed pending such a project.

While sampling and error evaluation should be addressed more generally, there are specific issues for estimates such as the valuation of financial instruments that require the Board's attention. Examples of those issues are discussed in the next several paragraphs. We believe that ISA 530 *Audit Sampling* does not provide sufficient requirements or guidance to address these matters.

Where an auditor develops his or her own estimate to test the values of financial instruments in a portfolio, guidance is needed for setting sample sizes, setting thresholds for investigating differences, reviewing and investigating differences, identifying errors, and extrapolating and evaluating errors. For example, while paragraph A128 of the ED refers to ISA 520 *Analytical Procedures* in setting point estimates and ranges, the guidance on determining which differences do not require investigation in paragraph A16 of that standard is too general and is not sufficient to promote consistent application by auditors in practice. ISA 520 does not address fundamental questions such as: (i) how to set thresholds having regard to materiality, the precision required and the nature of the population; (ii) whether to address assessed risks by seeking greater precision in setting thresholds; and (iii) how to set thresholds for disaggregated populations. There is a risk that the auditor sets thresholds that are large enough to allow for differences caused by the auditor using different pricing sources from those used by management, rather than setting thresholds for the precision required. Similarly, if the auditor attributes differences identified to using different pricing sources, this would defeat the purpose of testing client values by using different pricing sources. For example, where an auditor is unable to find a suitable pricing source to capture inputs in the same time zone or on the same date as used for valuation by management, it would not be appropriate to compensate by increasing the acceptable thresholds to allow for the volatility in inputs or values over time, rather than focusing on the level of precision required.

To address issues in practice, the standard should specifically state that it is not appropriate to set thresholds based on tolerable differences in individual inputs (e.g. point differences in interest rates) without also quantifying and evaluating how those tolerable differences would impact point estimates and ranges used by the auditor to evaluate amounts in the financial statements.

Auditors may also be uncertain as to how to extrapolate and evaluate errors. This may include cases where values of an instrument recorded in the financial statements could be positive or negative (e.g. interest rate swaps) and errors identified from sample selections could be in opposite directions. This matter is not addressed in ISA 520 or in ISA 530.

If these matters are not dealt with in the revised ISA 540, they should be given high priority in a separate project.

Reasonable ranges (paragraphs 20 and A2)

The term 'reasonable' is used throughout the ED and paragraph 20 requires the auditor's range to be reasonable when used to evaluate management's point estimate. While paragraph A2 describes the concept of 'reasonable', it is subjective and general in nature. The Board should provide more guidance and key considerations to facilitate practical application of the term 'reasonable.'

It is also important to remind auditors to exercise their professional skepticism in developing the reasonable range and not to set too wide of a range or threshold when auditing management's accounting estimate. Further, it is important for auditors to be aware as to when it is appropriate for them to rely on their own development of a range to evaluate the reasonableness of management's point estimate, and in which situations auditors need to undertake supplemental audit procedures. An example of the latter case may be a situation in which an auditor's range for an accounting estimate may be multiples of materiality for the financial statements taken as a whole, as described in A134. It would be helpful for the Board to provide further guidance in this area in a final standard.

The guidance currently in paragraphs A128 to A134 is not sufficient. Therefore, the Board should provide clearer guidance on how to:

- Set a reasonable range or threshold in testing management's accounting estimate;
- Evaluate the variance between auditor's point estimate or range and management's accounting estimate and highlight the importance of investigating the underlying root causes of such variance (particularly when there is contradictory evidence from other audit procedures); and
- Identify and evaluate errors. This includes extrapolation of errors to the relevant population and evaluating the risk of incorrect acceptance due to root causes of variances not being identified. ISA 530 and ISA 520 do not provide requirements or guidance to address these matters.

Paragraph 20 should also refer to guidance on developing an auditor's point estimate or using an auditor's range in paragraphs A128 to A134.

Paragraph A131 allows the auditor to develop a point estimate or a range for only part of the accounting estimate. The Board should consider providing further guidance and examples of this approach. The Board should also highlight that if the auditor develops a range in testing the underlying data or assumptions of the accounting estimate, there should be an assessment of variances and reasonableness of the accounting estimate in monetary terms. For example, the impact on the financial report may be difficult to assess from differences in non-monetary inputs such as interest rates, percentages or ratios. Assessing the impact on the financial report in monetary terms enables the auditor to better understand the impact of differences in estimates. While paragraph A131 of the ED provides examples of ways to develop a point estimate or range, it does not discuss identifying differences or evaluating errors.

Estimation uncertainty for populations with small number of high value items

A final standard should address the issues of estimation uncertainty with populations containing a small number of high value items compared to populations containing a high number of low value items. Where the population contains a small number of high value items (e.g. models for impairment of non-financial assets or recoverability of a single large disputed debt) and an auditor's range of values is broad, the auditor would need to consider whether to perform additional audit procedures. Prominent disclosure may be required under the reporting framework concerning the estimation uncertainty, but disclosure by management is not a substitute for the auditor to obtain reasonable assurance and sufficient audit evidence with respect to management's estimates.

Where a population contains a large number of low value items, the law of averages may assist in addressing estimation uncertainty (e.g. large numbers of small insurance contracts). However, there should also be guidance concerning the possibility of estimation bias in populations of a large number of low value items, that could result in material misstatements. For example, where differences between management's and auditor estimates are all in the same direction but each is less than the threshold, there could still be a material misstatement in aggregate. There may be other patterns or trends in differences identified.

Evidence to support an estimate and disclosures

Paragraph 19(a)(ii) of the ED says that the auditor's evaluation of whether an accounting estimate, and related disclosures, are reasonable in the context of the applicable financial reporting framework includes obtaining sufficient appropriate audit evidence to support the reasonableness of management's conclusions. To the extent the auditor is unable to obtain sufficient appropriate audit evidence, there should be application guidance on potential

impacts to the audit opinion and whether reporting the matter to those charged with governance is necessary. Given practice issues noted by some members, we believe that it is important to remind the auditor to consider the impact on their opinion in ISA 540 rather than to rely on the general requirements in paragraph 17 of ISA 700 *Forming an Opinion and Reporting on Financial Statements*.

Information sources

In describing the nature of accounting estimates, the ED says that the susceptibility of an estimate to misstatement may increase because of the need to "Appropriately consider the relevance and reliability of the data used, whether the data is obtained from internal sources or from external information sources" (paragraph 3(a)(ii)).

The proposed amendments to ISA 500 provide a definition of an external information source and considerations when evaluating the relevance and reliability of information obtained from such a source. In particular, paragraph 5(cA) of ISA 500 defines an external pricing source as an individual or organization that provides 'publicly available' information used by the entity in preparing the financial statements. However, it is not clear what is meant by 'publicly available'. For example, it is not clear whether 'publicly available' information needs to be available to the general public or whether the definition would also encompass circumstances in which information is not available to the general public but is nevertheless provided in a uniform manner to the interested users of an information source, for example on a subscription basis. Examples may include results of surveys of a small number of industry participants by industry associations or central banks that may not be public but only available to entities in the industry.

The Board should consider clarifying its definition of an external information source in this regard. Guidance may also be useful where the audited entity is the price maker in a particular market.

In discussing the evaluation of external information sources, paragraphs A33A to A33G of ISA 500 appear to focus on the relevance and reliability of those sources. As the Board observed in paragraph A33C, in many circumstances the auditor may not be able to test the accuracy and completeness of the information received from an external information source. For example, there may be no contractual relationship between the external information source and the entity that requires the provision of information, or the models used by external information sources may be proprietary.

However, in the example provided in the same paragraph, the Board appears to suggest that evaluating the relevance and reliability of information would only be a 'part of considering the accuracy and completeness of the information'. This may be confusing to auditors when

it comes to the extent of procedures that they would be expected to perform with reference to information received from an external information source. The Board should clarify its expectations regarding the criteria for evaluating information from external information sources, i.e. whether such information should be evaluated solely for its relevance and reliability while accuracy and completeness would be the appropriate evaluation criteria for information generated by the entity subject to the audit.

If the auditor is not able to evaluate a proprietary model used by external providers or to evaluate the relevance and reliability of information from an external information source, the auditor may need to consider whether there is a limitation of scope and whether a modified audit opinion is needed. The Board should provide further guidance to auditors in this respect.

The proposed amendments to ISA 500 do not cover internal information sources and should do so.

The revised ISA 540 should also make a distinction between internal and external information sources where internal information may be more subjective and more likely to be exposed to the risk of inappropriate management bias whereas external information may be perceived to be more objective.

Management experts and third party pricing providers

Due to increasing complexity in products and models (e.g. financial instruments), management often uses the assistance of external experts with the estimation process, or uses third party pricing providers or brokers' prices. The Board's proposed amendments to ISA 500 will not provide sufficient guidance for auditors in these areas.

Greater guidance is required on auditing accounting estimates prepared by, or using the work of, third parties, including how the auditor can reasonably obtain sufficient and appropriate audit evidence on the method, significant data and significant assumptions underlying such estimates (particularly when limited information is provided by the third parties to management). This could help to clarify how the objectives and audit procedures would be different or similar to those currently in paragraphs 17-19.

Use of the auditor's own experts

Under ISA 500 *Audit Evidence* the auditor needs to appropriately evaluate the work of management's expert if the information is to be used as audit evidence. ISA 500 defines audit evidence as including information in the financial records underlying the financial report.

Some members believe that the Board should give priority to a further project to develop additional guidance where management uses experts in developing accounting estimates. Other members do not believe that any additional guidance is required.

The first group of members believe that the revised ISA 540 or a revised ISA 500 *Audit Evidence* should be clarified by stating that auditors cannot rely on the work of management's expert and must perform sufficient audit testing on that work. Otherwise, the expert would in effect be playing a significant role in preparing the information in the financial report with no independent assurance by the auditor, which undermines the objective of having an independent audit. If the audit team does not have sufficient experience and expertise to perform audit work on an accounting estimate, the audit team should consider engaging their own internal or external expert.

While these members believe that the existing standards should be interpreted as requiring auditors to perform audit work on accounting estimates developed by using the work of management's experts, these members are concerned that there are instances where auditors are of the view that the existing standards do not require audit work other than seeing that the expert is purported to have appropriate qualifications and/or experience.

Paragraph 8 of ASA 500 refers to cases where "information to be used as audit evidence has been prepared using the work of a management's expert". It may be useful to provide guidance for cases where management's experts have been used in developing accounting estimates, and for cases (if any) where management's experts are used to test the accounting estimates. In both cases, these members believe that the auditor should not abrogate responsibility and rely on the work of management's expert, and that the auditor must perform sufficient audit testing.

The second group of members are of the view that the auditor can rely on the work of management's experts, including where those experts develop the accounting estimates used in the financial statements. However, these members are of the view that the auditor should still perform some audit testing on that work and not adopt a full reliance approach.

The first group of members believe that paragraph 8 of ISA 500 and paragraph 7 of ISA 620 *Using the Work of an Auditor's Expert* include requirements that are subjective and which should be supported by stronger guidance.

These members believe that ISA 620 *Using the Work of an Auditor's Expert* should also be revised to provide improved guidance. In practice, some auditors have read paragraphs A8 and A9 in ISA 620 as indicating that auditors do not need to use their own expert if management has used an expert, management's expert is an external expert, the expert has suitable qualifications and experience, the expert is subject to professional requirements, or the entity has controls over the work of the expert. Some members have observed that

paragraph 8 of ISA 500 has been interpreted in practice as requiring the auditor to do little more than assess the competence of management's expert. Paragraph A48 of ISA 500 only provides considerations in evaluating the work of management's expert "as audit evidence", and only one of those considerations "may include" the relevance and reasonableness of significant assumptions and methods. The work of management's expert should not be regarded as audit evidence in itself and should be subject to audit procedures that involve obtaining sufficient appropriate audit evidence. Further guidance is required to ensure that auditors use their own internal or external expert, unless the auditor has sufficient and appropriate skills, experience and expertise to undertake the necessary work.

Specific guidance on financial instrument valuation and related areas

The project to develop a revised ISA 540 was originally intended to result in guidance on auditing financial instrument values and loan loss provisioning under the expected credit loss model. While there is some guidance in the proposed amendments to ISA 500, the ED does not contain specific requirements or guidance in these areas.

We appreciate the imperative to issue a revised version of ISA 540 before IFRS 9 *Financial Instruments* is in effect for years commencing on or after 1 January 2018, and that the ED provides high level requirements and guidance for audit work across a broad range of accounting estimates. However, we believe it is important to provide specific guidance on the audit of accounting estimates in areas such as financial instrument valuation, loan loss provisioning under an expected loss model, impairment of non-financial assets, tax balances, and valuation of insurance policy liabilities.

We encourage the Board to provide supplemental guidance in these areas as a high priority after the release of the revised ISA 540.

Professional skepticism

As referred to in paragraph 5, the application of professional skepticism by the auditor is particularly important to the auditor's work relating to accounting estimates. While there are requirements in ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Statements on Auditing* concerning professional skepticism, there is a lack of specific guidance on what constitutes 'professional skepticism', including its meaning and definition, as well as specific application procedures related to auditing of accounting estimates. We encourage the Board to provide greater guidance in these areas throughout ISA 540.

Stand back provisions

The stand back provisions in paragraph 22 currently only refer to paragraphs 17 to 19 relating to situations where risk has been assessed as 'not low'. The stand back provisions should apply whether risk is assessed as 'low' or 'not low'. It is important to review whether the risk assessment at the assertion level remains appropriate when the assessment was 'low' given that the nature and extent of work may have been insufficient (paragraph 22(a)). It is also relevant to assess whether sufficient audit evidence has been obtained (paragraph 22(b)) and to review management's decisions under the reporting framework (paragraph 22(c)) even where risk was assessed as low.

The stand back provisions in paragraph 22(a) should also require the auditor to reassess the appropriateness of any reliance on controls, and the effect of any changed assessment on the nature, timing and extent of audit procedures.

Paragraph 23 requires the auditor to consider all relevant audit evidence obtained whether "corroborative or contradictory" when evaluating whether the accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework. While recognizing that paragraph 22(b) would require the auditor to evaluate whether sufficient and appropriate audit evidence has been obtained, paragraph 23 should be amended to focus on whether the auditor has exercised sufficient professional skepticism. Professional skepticism involves challenging management's estimates and assumptions, rather than mere corroboration. The auditor should consider whether to obtain more evidence to challenge rather than corroborate accounting estimates and related disclosures, and whether the auditor has sufficiently challenged the accounting estimates. This is in addition to considering contradictory evidence. For example, the auditor might benchmark assumptions against other entities in the industry, consider legislative changes that affect future cash flows, or have regard to whether asset values are consistent with the entity's market capitalization.

Documentation

Paragraph 27 would require, among other matters, documentation of the auditor's evaluation of the reasonableness of the accounting estimates and related disclosures and indicators of possible management bias. Despite the general nature of this requirement, it does not capture other important matters that we believe should be documented.

Given that the revised ISA 315 on risk assessment has been delayed, the revised ISA 540 should specifically require documentation on the process for assessment and classification of inherent risk ('low' or 'not low'), the reasons for that classification and responses to the assessed risks of material misstatement.

Further, where an accounting estimate involves the use of complex models (e.g. impairment testing of non-financial assets), the auditor should retain a copy of management's model and any model prepared by the auditor or their expert in a readily reviewable format (e.g. Excel) to enable another experienced auditor having no previous connections with the audit, to understand the model and how it works, the work performed and the reasons for the conclusions reached. However, the Board may need to provide guidance to address the impact of proprietary models.

Where there are a large number of complex valuation models for different items (e.g. life insurance policy liabilities or financial instruments), the auditor should perform testing using his or her own independent models, or clearly document management's models tested and the testing performed.

Reference should also be made to the general requirements in ISA 230 *Audit Documentation*.

Definitions

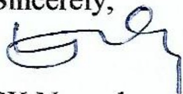
The Board should provide further clarification on the following definitions:

- *Accounting estimate*: Paragraph 9(a) includes the term 'monetary amount.' It is not clear whether this encompasses an estimate of zero and whether it includes disclosures of non-monetary amounts.

- *Fair presentation framework* and *compliance framework*: These terms are used in paragraph 21 and should be cross referred to the definitions in ISA 200 *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*.

Thank you for the opportunity to comment on the exposure draft. If you have any questions or would like to further discuss these matters, please contact Doug Niven on ph. +61 2 9911-2079 (email: douglas.niven@asic.gov.au) or Nigel James at ph, + 1 202-551-5300 (email: jamesN@sec.gov). In case of any written communication, please mark a copy to me (email: nagpal@sebi.gov.in)

Sincerely,



PK Nagpal
Chair, Committee on Issuer Accounting, Audit and Disclosure
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