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Prof. Arnold Schilder
Chair
International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, NY 10017

Re: Comment Letter on Auditing Accounting Estimates and Related Disclosures

Dear Prof. Schilder,

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the International Auditing and Assurance Standards Board's ("IAASB" or "Board") Exposure Draft ("ED"), *Auditing Accounting Estimates and Related Disclosures*.

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

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1 With offices in Charlottesville, New York, Hong Kong, London, Mumbai and Beijing CFA Institute is a global, not-for-profit professional association of more than 133,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 151 countries, of whom more than 125,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 145 member societies in 70 countries and territories.

2 The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

Introduction

As set out in the Explanatory Memorandum to ED 540, the proposals are intended to modernize extant ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, for the following reasons:

- The anticipated auditing challenges arising from the new international accounting standard, IFRS 9 *Financial Instruments*,
- Management's increasing use of external information to make estimates,
- The ongoing criticism of auditors' inadequate assessment of risks of material misstatement by not considering inherent risk factors such as increased complexity of business environment and increased complexity in financial reporting frameworks,
- Inconsistent disclosures, and
- Lack of focus on professional scepticism.

Recent accounting standards (IFRS 9 *Financial Instruments*, IFRS 15 *Revenue Recognition*, IFRS 17 *Insurance Contracts)* increase significantly the use of, and the reliance on management judgement when making accounting estimates. This often requires the use of complex models and long forecast periods. This combined with the deficiencies in auditing accounting estimates as identified by the PCAOB and IFIAR, are strong reasons for the IAASB to update the standards for auditing accounting estimates. We believe that audit standard setters need to consider these developments as well as investor interests and ensure rigorous audit requirements for accounting estimates and the underlying judgements made by management. Furthermore, investors need comprehensive disclosures on these estimates and judgements. Inconsistent disclosures has been an issue for users. Thus ED 540 is an important step into the right direction. With greater focus on professional skepticism, more granular risk assessment requirements, and the proposed 'stand back',[3] we believe the ED will lead to higher audit quality.

This proposal is important as it also encompasses the reliability of valuation of assets and liabilities reported on a fair value basis. As reflected in several member surveys and articulated in our commentary (e.g. 2007 Comprehensive Business Reporting Model) over the last several years, CFA Institute has consistently supported fair value measurement (FVM) as a basis of recording assets and liabilities in the financial statements.

Under both US GAAP and IFRS, fair value measurement is applicable in the recognition, measurement and disclosure of a wide array of financial instruments, impairments of financial instruments, non-financial asset impairments, assets acquired and liabilities assumed in business combinations - intangible assets, contingent consideration, stock-based compensation, net pension obligations and asset retirement obligations.

Given the widespread application of FVM by both financial and non-financial companies and the usefulness of these measures, the rigorous audit and reliability of FVM estimates is critical for investors.

[3] The IAASB decided to include a stand back provision, which requires the auditor to evaluate whether, based on the audit procedures performed and the audit evidence obtained, the assessed risks of material misstatement remain appropriate; sufficient appropriate audit evidence has been obtained; and management's decisions relating to the recognition, measurement, presentation, and disclosure of these accounting estimates in the financial statements are in accordance with the applicable financial reporting framework.

Another challenge for investors analyzing financial statement estimates is that they tend to have limited accompanying disclosures. Disclosures typically contain little information on the inputs and assumptions made with regard to estimates. In some cases, there is little information other than the number and some generic language with respect to how, in fact, the estimate was derived. Hence, we support ED 540's emphasis on consistent and robust disclosures.

Below we outline our detailed comments on the significance of the stand back provision as well as the focus on professional skepticism and disclosures, the specific risk assessment requirements outlined in the ED, the importance of communication with those charged with governance, and the need to align standard setting with the US Public Company Accounting Oversight Board (PCAOB). Finally, we underscore the need for field testing the proposal in order for investors to assess whether the changes are economically worthwhile.

Professional Skepticism

CFA Institute believes professional skepticism is central to delivering a rigorous and high quality audit. We agree with the approach taken in the proposal to begin by emphasizing the importance of professional skepticism followed by requirements and application material that drive professionally skeptical behavior.

Important aspects of applying professional skepticism, especially with regard to estimates, are to evaluate management's methods and judgments, consider whether other methods and judgments may be more appropriate, and challenge management on their methods and judgements. A critical concern is the consistent use of boilerplate disclosure of the significant judgments and assumptions used by management over time. Professional skepticism would strongly suggest that a dynamic market place calls for changes in assumptions over time. The audits of such disclosures need to ask why these disclosures are static and uninformative. We thus contend the auditor should be encouraged to challenge management in this respect.

We also urge the IAASB to finalize its separate project on professional skepticism as a matter of priority as that project may lead to further requirements to reinforce the use of professional skepticism in the context of estimates.

While this is beyond the purview of the IAASB, we believe measures to strengthen professional skepticism should extend to those charged with governance, especially audit committees.

Stand Back

We support the enhanced risk assessment requirements and the requirements to "stand back" and evaluate audit evidence obtained regarding the accounting estimates, including both corroborative and contradictory audit evidence. Given the iterative nature of an audit, audit quality would be enhanced by requiring the auditor to take stock of the audit evidence obtained in relation to accounting estimates, particularly complex and challenging accounting estimates.

We also support the guidance in the application material that notes when the auditor may conclude that an accounting estimate is reasonable and when then auditor should reconsider whether sufficient appropriate audit evidence has been obtained.

CFA Institute believes that these are the two key provisions in the proposal. What these result in is the need for the auditor to take an independent view of the estimates rather than merely check the accuracy of management computations. To the extent that estimates are based on models, the auditor must consider whether there are other models and inputs that could have been used and whether other models or inputs would result in significantly different estimates.

Specific Risk Assessment Requirements

We support the proposal's specific risk assessment requirements in paragraphs 10 through 13. We believe that the requirements support more effective identification and assessment of risks of material misstatement relating to accounting estimates.

Need for Better Linkage Between Audit Procedures and Audit Evidence

We also support the requirement in the proposal for the auditor to take into account the extent to which the accounting estimate is subject to, or affected by complexity, judgment, and estimation uncertainty in identifying and assessing risks of material misstatement. We believe this is necessary to arrive at an appropriate audit response to more complex accounting estimates, rather than just concentrating on estimation uncertainty.

We do, however, believe that the proposal would benefit from linking the audit procedures in paragraph 15(a) when inherent risk is low, to the audit evidence required to be obtained in paragraphs 17 through 20 – along the lines of what is provided in the flowchart on the IAASB website. We believe that this will provide greater clarity and enable auditors to more effectively apply the standard.

Disclosures

CFA Institute supports paragraphs 21 (a) and A135 through A138 of ED 540 that requires that the auditor shall obtain sufficient appropriate audit evidence about whether the disclosures related to accounting estimates are reasonable in the context of the requirements of the applicable financial reporting framework including:

> "(a) In the case of a fair presentation framework, whether management has provided the disclosures beyond those specifically required by the framework that are necessary to achieve the fair presentation of the financial statements as a whole."

With increasing use of accounting estimates it is important for users making investment decisions to understand the model, the inputs and the assumptions made by management, and the extent to which accounting estimates are subject to estimation uncertainty. As stated previously, it is a challenge for investors to understand what is behind these estimates, how they are derived, and what they mean economically. We believe such information should be provided through the disclosures in the financial statements. However, given that some financial reporting frameworks do not provide for specific disclosure requirements at a detailed level, from a user perspective, paragraph 21 (a) is necessary as it requires auditors to request additional disclosures when necessary to achieve fair presentation of the financial statements as a whole under the relevant financial reporting framework. Sufficient disclosures related to accounting estimates are essential for effective communication of key audit matters to investors. Disclosures are especially necessary whenever there is extreme measurement uncertainty[4] associated with the reported point estimates of assets and liabilities.

We do, however, urge the IAASB to provide additional application guidance related to paragraph 21(a), such as examples of circumstances in which management might provide disclosures beyond those specifically required by the framework that are necessary to achieve the fair presentation.

Communication

CFA Institute agrees with paragraph 26, A155 and A156 of ED 540 whereby:

> "the auditor is required to communicate with those charged with governance or management about certain matters, including significant qualitative aspects of the entity's accounting practices and significant deficiencies in internal control, respectively. In doing so, the auditor shall consider the matters, if any, to communicate related to the extent to which the accounting estimates and their related disclosures are affected by, or subject to, complexity, the need for the use of judgment by management, estimation uncertainty, or other relevant factors."

Investors and analysts seek more disclosures of accounting estimates, more information on how these estimates have been audited, and communication of key audit matters. Paragraphs 26, A155 and A156 place more emphasis on communication between auditors and those charged with governance regarding accounting estimates. For investors to effectively communicate with those charged with governance, it is essential that those charged with governance first discuss accounting estimates and key audit matters thoroughly with auditors.

We welcome the discussion of the risk of management bias when auditing accounting estimates in the application material. But we believe the evaluation of management bias should be included through the entire audit process. We also believe the section on communication with those charged with governance should include a discussion of management bias.

With respect to estimates there is a risk of confirmatory bias. Hence the need to challenge management, the application of professional skepticism, and the stand back provision are extremely important.

As stated above, CFA Institute believes that investors need greater insight as to how estimates are derived. We also believe audit committees need to be more proactive in asking details regarding assumptions made by management. To provide these two important constituents with necessary information regarding the audit of accounting estimates, we hope the information is included in the new auditors reporting model.

Specialized Skills

We agree with the new objective-based approach to developing responses to risks of material misstatement. We believe it allows for the flexibility needed to address different types of accounting estimates, whilst driving more consistent and detailed work effort to obtain sufficient audit evidence.

[4] For example, estimation uncertainty occurs when the range of possible estimates is several factors of materiality.

From an investor perspective, one of the most important questions is whether the auditor has the requisite skills, knowledge and experience to audit these estimates. Investors want auditors to make a robust risk assessment and to have an understanding of the current economic context and for auditors to use this in assessing estimates. For example, are implications of the low-interest rate environment being incorporated by the auditor into their assessments of the estimates and assumptions going into the financial statements. Therefore, the auditor at every stage of the audit should consider whether he/she has the requisite skills and competencies. The lack of appropriate skills to conduct the audit of accounting estimates we believe is the root cause of many of the problems we see today.[5]

We welcome the requirement that the auditor needs to determine early in the audit process whether specialized skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. However, the importance of the use of specialized skills and knowledge should be highlighted in all phases of the audit of accounting estimates such as planning, performing testing of controls and detailed testing.

We also believe the ED should highlight any differences in audit procedures to be undertaken when the specialist is employed by the audit firm and when the specialist is employed by the audit firm's client.

Scalability

We believe that "low inherent risk" is the appropriate gauge for scalability and using it in the standard should be applicable to all estimates. We believe that the standard is sufficiently clear and capable of proportionate application to estimates that have risks of material misstatement for which inherent risk is low. We note, however, that there is some danger in auditors seeing this as a dividing line and perhaps assessing some estimates as having low inherent risk when in fact they do not. This would be a matter for audit regulators to monitor.

PCAOB

In the Explanatory Memorandum, the IAASB outlines its extensive outreach activities, including with the PCAOB. We also note that the PCAOB issued *Docket 43: Proposed Auditing Standard for Auditing Accounting Estimates, Including Fair Value Measurements,* on June 1, 2017 and that the PCAOB's proposed changes build on the existing approach to auditing estimates. We note various differences between the PCAOB's proposal and those of the IAASB. Close alignment between the IAASB and PCAOB standards on auditing accounting estimates is in the public interest and we urge the IAASB to continue its outreach activities with the PCAOB with the goal of achieving closer convergence.

ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*

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[5] For example, a report, *Survey of Fair Value Audit Deficiencies* – by Atlanta-based valuation and litigation consultancy firm, Acuitas, Inc. – reviewed PCAOB inspection reports for 2008-2011 and reported that approximately one-fourth of all audit deficiencies reported by the PCAOB related to fair value estimate audit deficiencies. The study notes the primary causes of such deficiencies related to: pricing, failure to test, disclosures, risk assessment, prospective financial information, and other-than-temporary investments.

It is unfortunate that the project to revise ISA 315 could not have taken place at the same time as the development of ED 540. ED 540 proposes a different risk model for risk assessment related to the audit of accounting estimates compared to extant ISA 315. ISA 315 broadly distinguishes between significant and non-significant risks. The ED on the other hand recognizes low and high inherent risk, in addition to significant risk. We urge the IAASB to clarify the relation of the risk model in the ED relative to the current requirements of ISA 315.
Had the two projects been undertaken concurrently, the types of risks, including significant risk, could have been aligned. As it stands now, we are unable to determine whether further changes to the revised ISA 540 will be needed when future revisions are made to ISA 315.

ISA 500 *Audit Evidence*
We agree with the need to clarify the distinction between a third-party pricing source and a management's expert and the necessary amendments to ISA 500. We support the proposed conforming and consequential amendments to ISA 500, regarding external information sources, including the following:

- The definition of external information source including application material to assist the auditor in determining whether audit evidence was from an external information source.
- Application material regarding factors related to the relevance and reliability of information obtained from an external information source, specific material on fair value measurements, and when management and the auditor use the same information source.

We also suggest that ED 540 reference ISA 500, paragraph 8, which discusses requirements for information to be used as audit evidence that has been prepared using the work of a management's expert. Underscoring the requirements for evaluating the work of a management's expert, we believe, will help ensure high audit quality.

Field Testing
The IAASB has invited auditors to participate in field testing of the proposals. We applaud this as it could provide helpful insights. Any issues identified by the auditors should be explored very carefully and any changes made in response should be done after following due process, having regard to the public interest.

It is particularly important for investors as it is difficult for them to assess whether the changes are economically worthwhile and solving the issues they have faced.

International Auditing Practice Notes (IAPN) and Implementation Issues
We understand that the ISAs are principles-based. Consequently, the proposal does not address the many emerging accounting requirements. However, it would be useful to have separate guidance to apply the standard to different types of complex estimates. We believe this could be done perhaps through IAPNs. Areas that could be covered are estimates of expected credit losses under IFRS 9, as well as new accounting standards covering leases, revenue recognition and insurance contracts.

Further, provisioning under the new Expected Credit Loss (ECL) model and auditing of these estimates under ISA 540 (Revised) might raise implementation issues. We, therefore, urge the IAASB to address issues that may arise and provide additional guidance, if necessary.

Effective Date
We believe that an 18-month transition period for the effective date is appropriate.

Sincerely,

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Financial Reporting Policy
Advocacy Division
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/s/ Ashwinpaul C. Sondhi
Chair
Corporate Disclosure Policy Council

cc: Corporate Disclosure Policy Council