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August 3, 2017
Mr. Matt Waldron
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
529 5th Avenue, 6th Floor
New York, NY 10017 USA

Dear Mr. Waldron,

Re: JICPA Response to the Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

The Japanese Institute of Certified Public Accountants (JICPA) is grateful for the opportunity to comment on the Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures.*

The increasing complexity of business environments has raised estimation uncertainty in accounting estimates. In response to it, the financial reporting frameworks developed by each accounting standard setter have been continuously evolving. The role of the disclosures relating to estimates in the financial statements has accordingly been becoming ever more important in assisting users' understanding of estimation uncertainty. We recognize that the revisions relating to the disclosures (Objectives (paragraph 8), Requirements (paragraphs 19(a) (ii), (b) and 21) and relevant Application Materials) are very important which reflect this growing importance of disclosures.

At the same time, we believe there are areas where just changing auditing standards will not necessarily be sufficient to achieve the aim of the revisions. For example, for additional disclosures to be provided for users' understanding even when the disclosures of estimation uncertainty are in accordance with the applicable financial reporting framework (paragraphs A124 and A125), not only the auditor but also management and those charged with governance themselves, need to have an attitude of being willing to make such disclosures. In addition, it is necessary that users proactively demand such information from the entities, and that regulators and accounting standards setters establish an environment that encourages such additional disclosures.

Therefore, in order to achieve the aim of the revisions, it is essential that each stakeholder in the financial reporting supply chain, including users, management, those charged with governance, auditors, accounting standard setters and regulators, commits themselves toward better financial reporting, and fulfills their responsibilities. We will continue our efforts on outreach and dialogue with relevant stakeholders toward better financial reporting, in conjunction with our commitment toward improvement of audit quality.

The following are our comments on matters that we consider to be addressed, including some of the questions in “Request for Specific Comments.”

Our Comments on the Questions in "Request for Specific Comments"

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?

We believe following requirements in ED-540 are not sufficiently scalable with respect to auditing accounting estimates with low inherent risk.

- Risk Assessment Procedures (Paragraph 10)
  Paragraph 10 seems to require the auditor to evenly obtain an understanding of all items listed in paragraph 10 in all cases with regard to each of all accounting estimates in financial statements. We believe, however, that it is not always necessary to understand how management has identified and addressed the risk of management bias (i.e. paragraph 10(c)(v)) concerning accounting estimates with low inherent risk, including the simple accounting estimate, for example, that is quantitatively trivial and that necessitates little management judgment.

  Therefore, we propose to clarify in the standard that: (1) paragraph 10 does not intend to require the auditor to obtain detailed understanding of all items listed in paragraph 10 for each individual accounting estimate in all cases; (2) the auditor obtains understanding to the extent necessary to design further audit procedures, and (3) the nature and extent of necessary understanding varies depending on the importance of the accounting estimate to the financial statements.

- Responses to the Assessed Risks of Material Misstatement (Paragraph 15(a))
  For accounting estimates with low inherent risk that are quantitatively trivial, we do not consider procedures in paragraph 15(a) (i) to (iii) to be required in all cases.

  In June 2017, US PCAOB released their proposed auditing standard for auditing accounting estimates ("PCAOB proposal"), and the PCAOB proposal requires the auditor to apply substantive procedures to accounting estimates in significant accounts and disclosures (PCAOB Proposal Appendix 1, paragraph 5). We understand that IAASB is undertaking the project to revise ISA 315, which includes exploring whether to introduce the concept of the identification of significant classes of transactions, account balances and disclosures in identifying and assessing the risks of material misstatement that is similar to the concept used in PCAOB standards. We believe introduction of this concept may also respond to the issue of scalability of ISA 540. Therefore, this concept should also be explored in the project for the revision of ISA 540.

4) When inherent risk is not low (see paragraphs 13, 15 and 17–20): 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 support that ED-540 requires the auditor to take into account the extent to which the accounting estimate is subject to, or affected by, one or more relevant factors. However, we consider that further clarification is necessary about the interrelationship between the three factors (i.e. complexity, judgment and estimation uncertainty). We understand that the third

sentence of paragraph 2 (“The extent to which they are subject to, or affected by, complexity and judgment is often related closely to the extent to which they are subject to, or affected by, estimation uncertainty.”) and the last sentence of paragraph A113 (“This is important so that the selection of management’s point estimate, and the development of related disclosures, is based only on estimation uncertainty.”) in ED-540 intend to explain the interrelationship between the three factors. However, it does not clarify the implication that this interrelationship has on the auditor’s procedures.

As implied in the definition of accounting estimate (paragraph 9(a)), estimation uncertainty is an inherent characteristic of accounting estimates. Therefore, when inherent risk is not low, we cannot imagine the situation where estimation uncertainty is not included in the reasons for the assessment given to the risk of material misstatement (in other words, where paragraph 19 is not applicable).

Based on this interrelationship, when inherent risk is not low, we expect the auditor to start with the procedures that respond to complexity and judgment factors (paragraphs 17 to 18), ending with those that pertain to estimation uncertainty, which is the inherent characteristic of the accounting estimates (paragraphs 19 and 20). This flow (paragraphs 17 to 20) is not clear from the context of ED-540. In order to assist the auditors in applying the requirements in paragraphs 17 to 20, we propose to add in Application Materials relevant to paragraph 15(b), for example, an explanation that clarifies the interrelationship between requirements in paragraphs 17 to 20.

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 agree with the revision of paragraph 7 and addition of related Application Materials in ISA 500. However, we consider the structure of paragraph A33H needs reconsideration. Paragraph A33H provides guidance when management and the auditor use the same information source. The first sentence states that one of the examples of such a situation is when there is only one provider of certain information. The last sentence explains that, in such a situation, as an additional consideration, the auditor may access a different information source from that used by management to evaluate the external information source used by management. However, when there is only one provider of certain information, it is impossible for the auditor to access a different information source from that used by management. Therefore, we suggest deleting “for example, because there is only one provider of certain information” from the first sentence. Guidance relating to the case when there is only one provider of certain information should be included at the end of paragraph A33H with reference to the relevant guidance of paragraph A33C.

Comments on Specific Paragraphs of ED-540 (Revised)

- Auditor's Point Estimate or Auditor's Range / Substantive Analytical Procedures (paragraphs A97 and A128)

Paragraphs A97 and A128 explain that developing an auditor's point estimate or an auditor's range is substantive analytical procedures. We understand that there is a certain similarity between "developing an auditor's point estimate or an auditor's range" and "developing an expectation in substantive analytical procedures", since the auditor themselves develops a certain amount (or range) in both cases. However, we consider that developing an auditor's point estimate or an auditor's range is very different in character from other general substantive analytical procedures. Therefore, we do not support this categorization.

Analytical procedures are procedures to indirectly analyze the amount in the financial statements by using financial and non-financial data. On the other hand, developing an auditor's point estimate or an auditor's range is the procedure by which the auditor, by themselves, derives the amount (or range) of an accounting estimate. For example, when the auditor develops a point estimate or auditor's range by using a model that is commercially available for use in a particular sector or industry, or an expert-development or auditor-development model, we believe the auditor can obtain more persuasive audit evidence than those obtained from general substantive analytical procedures that analyze plausible relationships among data. In substantive analytical procedures, the variance between recorded amounts and expected values is not automatically treated as a misstatement. If the difference exceeds certain amounts that are acceptable without further investigation, the auditor is required to perform further investigation and it is usual that the auditor determines the amount of misstatement after performing other tests of details. On the other hand, regarding the auditor's point estimate or range, the difference between management's point estimate and auditor's point estimate or the nearest point of the auditor's range is automatically treated as a misstatement as stated in paragraph A145. If the auditor's point estimate or range is categorized as substantive analytical procedures, it will lead confusion as to whether the auditor is required to determine the amount of misstatement in accordance with ISA 520 or ISA 540.

We agree it is not clear from the existing ISAs as to which procedures the auditor's point estimate or range is categorized as. However, we are concerned that the approach of ED-540, which categorizes the auditor's point estimate or range as substantive analytical procedures and simply refers to ISA 520 (paragraph A128), may lead to unintended consequences relating to the provisions in the existing ISAs, such as :

- Paragraph 21 of ISA 330 states when the approach to a significant risk consists only of substantive analytical procedures, those procedures shall include tests of details. When the auditor does not plan to rely on control over a risk the auditor has determined to be a significant risk, ED-540 implies that the auditor is required to perform other tests of details in addition to developing an auditor's point estimate or range in all cases. We consider that it is not appropriate. As stated above, developing an auditor's point estimate or an auditor's range is very different in character from other general substantive analytical procedures.

- Paragraph A44 of ISA 330 states substantive analytical procedures are generally more applicable to large volume of transactions that tend to be predictable over time. However, due to the estimate's character of lack of precision in its measurement and existence of choice of models, assumptions, and data, developing an auditor's point estimate or an

auditor's range are procedures that the auditor derives the amount or range by themselves. Therefore, it does not fit the definition of analytical procedures that applies when there is a plausible relationship among data.

Therefore, we believe developing an auditor's point estimate or an auditor's range should be categorized as tests of details.

- Paragraph 17

There seems to be inconsistency between paragraphs 13 (a) and 17. At the beginning of paragraph 17 "management's use of a complex method" and "when management's method otherwise involves the use of specialized skills or knowledge" are referred to as factors of complexity. In addition to those two factors, paragraph 13(a) includes "the difficulty, if any, in obtaining relevant and reliable data and maintaining the integrity of that data" as a factor of complexity (paragraph 13(a)(ii)). We propose to simplify the structure of paragraph 17 like that of paragraph 18 or 19 as follows:
"In complying with paragraph 15(b), when the reasons for the assessment given to the risk of material misstatement include complexity in making the accounting estimate~~related to management's use of a complex method (including complex modelling), or when management's method otherwise involves the use of specialized skills or knowledge, the auditor shall obtain sufficient appropriate audit evidence about the following matters~~:…"

- The fourth bullet of paragraph A73

We propose to delete the clause "that is active in different markets". An expected credit loss model in a financial institution uses various assumptions and data from various information sources. Therefore, inherent risk is usually not low even if the financial institution only operates in one jurisdiction. If the board decides to retain the clause, we propose to change it to "that operates in different markets" to be simple to understand; As the word "active" is often used as an adjective that illustrates the market conditions, it is hard to understand what it means when used as an adjective to "the financial institution" in this bullet.

- Other paragraphs that need simplification and clarification

The following paragraphs are complex and the points are difficult to understand. We believe that use of more plain and simple wording is helpful:

- Paragraph 3: We understand paragraph 3 intends to provide explanation relating to the descriptions of the three factors in paragraph 13. However, some of the descriptions in the two paragraphs seem to be inconsistent, particularly those on estimation uncertainty (paragraph 3(c) and 13(c)). As paragraph 4 refers to laying emphasis on the three factors in identifying and assessing risks of material misstatement and designing and performing further audit procedures, we consider that paragraph 3 is not necessary and that it should be deleted.

- Paragraph A144: The word "amounts" is used several times. However, it is not clear whether "amounts" means "management amounts" or "auditor's amounts". Also, the fifth sentence uses the phrase "the amounts identified or supported". The difference between what "identified" and "supported" mean is not clear.

- Appendix 1, paragraph 23: The last sentence seems to repeat the same points as in the previous sentences and the intended meaning of this sentence is not clear.

- Appendix 2, the fourth bullet of paragraph 14: It is not clear what the phrase “relative likelihood” means.

- Appendix 2, paragraph 20: Overall, sentences are long and difficult to understand. We propose the following simplification:

  “In other cases, it may be necessary to consider information about past conditions and events, together with current trends and expectations about future developments. Past conditions and events provide historical information from which repeating historical patterns of behavior relating to uncertain valuation attributes may be discerned and extrapolated in evaluating future outcomes. Such historical information may also indicate changing patterns of such behavior over time (cycles or trends)~~. These~~, or may suggest that the underlying historical patterns of behavior have been changing in somewhat predictable ways~~ that may also be extrapolated in evaluating future outcomes~~. ~~Other types of information may also be available that indicate possible changes in historical patterns of such behavior or in related cycles or trends~~. Difficult judgments may be needed about the predictive value of such information.”

We hope that our views will be of assistance to the IAASB.

Sincerely yours,

Sayaka Sumida
Executive Board Member - Auditing Standards
The Japanese Institute of Certified Public Accountants