# Joint submission by

# Chartered Accountants Australia and New Zealand and The Association of Chartered Certified Accountants

**[28 July 2017]**

TO: Professor Arnold Schilder
The Chairman
International Auditing and Assurance Standards Board
529 5th Avenue 6th Floor
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Submission via IAASB website

This submission is made jointly by Chartered Accountants Australia and New Zealand and the Association of Chartered Certified Accountants under their strategic alliance.

ACCA and CA ANZ created their strategic alliance in June 2016, forming one of the largest accounting alliances in the world. It represents 800,000 current and next generation accounting professionals across 180 countries and provides a full range of accounting qualifications to students and business. Together, ACCA and CA ANZ represent the voice of their members and students, sharing a commitment to uphold the highest ethical, professional and technical standards.

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## About Chartered Accountants Australia and New Zealand

Chartered Accountants Australia and New Zealand is a professional body comprised of over 117,000 diverse, talented and financially astute members who utilise their skills every day to make a difference for businesses the world over.

Members are known for their professional integrity, principled judgment, financial discipline and a forward-looking approach to business which contributes to the prosperity of our nations. We focus on the education and lifelong learning of our members, and engage in advocacy and thought leadership in areas of public interest that impact the economy and domestic and international markets.

We are a member of the International Federation of Accountants, and are connected globally through the 800,000-strong Global Accounting Alliance and Chartered Accountants Worldwide which brings together leading Institutes in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support and promote over 320,000 Chartered Accountants in more than 180 countries

## About ACCA

ACCA is the global body for professional accountants. We aim to offer business- relevant, first-choice qualifications to people around the world who seek a rewarding career in accountancy, finance and management.

ACCA supports its 198,000 members and 486,000 students in 180 countries, helping them to develop successful careers in accounting and business, with the skills required by employers. ACCA works through a network of 101 offices and centres and 7,291 Approved Employers worldwide, who provide high standards of employee learning and development. Through its public interest remit, ACCA promotes appropriate regulation of accounting and conducts relevant research to ensure accountancy continues to grow in reputation and influence.

The expertise of our senior members and in-house technical experts allows ACCA to provide informed opinion on a range of financial, regulatory, public sector and business areas, including: taxation (business and personal); small business; audit; pensions; education; corporate governance and corporate social responsibility.

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## Joint Submission Comments

CA ANZ and ACCA appreciate the opportunity to comment on ED-540. In responding to the proposals and undertaking outreach with our members, we have considered whether ED-540 addresses the concerns that underlie the call for a revision of extant *ISA 540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* ("ISA 540"). We understand the key concerns to be:

- regulator findings that indicate that there is insufficient/inappropriate work effort by auditors in relation to auditing accounting estimates (during both the risk assessment phase and the gathering of audit evidence)
- lack of professional skepticism in challenging management's assumptions and biases in the auditing of accounting estimates
- lack of sufficient work effort and attention given by auditors to the disclosures in relation to accounting estimates, particularly in relation to the increasing complexity of estimates contained within accounting standards.

Before addressing the specific questions raised on ED-540 we have overall comments on whether ED-540 appropriately addresses these concerns raised about ISA 540.

**Insufficient or inappropriate work effort**

We recognize that it is important that auditors perform an appropriate level of work when auditing estimates and that the change from 'significant risk' to 'not low inherent risk' as the trigger for determining the work effort required by the auditor is an attempt to address this issue. However, our members have significant concerns that this will drive auditors to performing excessive work on estimates. Too much work in relation to an estimate, when it is not warranted by the nature of the estimate, has the potential to negatively impact audit quality, just as too little work can. ED-540 states that at times auditors may not identify and assess risk at a sufficiently granular level. However a blanket increase in work effort is not appropriate either. We believe that the key areas which need to be addressed in order for the final standard to appropriately direct the auditors' work effort are:

- Implementing a mechanism for evaluating the risk of the estimate (and thereby determining subsequent work effort) that is more flexible and is consistent with the concepts in ISA 315. The introduction of the low/not-low inherent risk concept is not useful. Our members' view is that it would be difficult to find many estimates that would not be categorized as 'not low' inherent risk, given the fundamentally judgmental nature of estimates. This is as true for the audits of very small entities as it is for the audits of large, listed companies. This will result in a higher than necessary level of work for many simpler estimates. It is also potentially confusing to have a mismatch between risk assessment as discussed in extant ISA 315 (based on significant risk of material misstatement) and 'not low' inherent risk in ED-540. The use of inherent risk to determine the auditor's procedures in relation to estimates is inconsistent with the approach taken in other standards, it is unclear which concept of inherent risk is being

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used and a lack of recognition that inherent risk is difficult to assess objectively in practice.

- Ensuring that the requirements in relation to the elements of estimation uncertainty, complexity and judgement are not overly prescriptive. Our members believe that, for any estimate categorized as 'not low' inherent risks, regulators will expect the auditor to address all three elements and, accordingly, fulfill the requirements for all three. This will drive auditors to a compliance mentality in relation to estimates as they will feel constrained to address all the issues for each of the three areas for every estimate in order to satisfy the regulatory interpretation. A compliance mindset does not improve audit quality and may reduce the exercise of professional skepticism and judgement. It is vital that the requirements in ED 540 are principles based. This is necessary to ensure that the standard remains valid as business activities and estimation approaches change, that work effort is applied to relevant matters and assertions, and that auditors are supported to appropriately exercise professional judgement and appropriately document their work in dealing with estimates.

- Taking a more integrated approach to assessing the risk of an individual estimate and determining the appropriate work effort. Our members expressed a view that in assessing the risk of an individual estimate, the separation of complexity, judgement and estimation uncertainty can feel artificial as, in reality, each of these feeds into each other. They suggested that the key driver of risk in an estimate is usually estimation uncertainty and that complexity and judgement are two factors to consider when determining estimation uncertainty. There may be circumstances in which judgement may be more important than estimation uncertainty, for example, a choice of presentation alternatives in which management may have biased motivation and these should be addressed by the auditor. This only further illustrates the need for a flexible and cohesive approach.

- Ensuring the standard is scalable. The ED lacks scalability. There is no recognition that there is scale of risk in relation to estimates and there seems to be little flexibility in how auditors address complexity, judgement and estimation uncertainty for any given estimate. ED-540 seems to be focused on complex estimates of the kind dealt with in the financial services industry and lacks guidance for auditors dealing with less complex estimates in other industries. Without scalability, the standards will force unnecessary work effort by auditors which will adversely impact audit quality as discussed above.

- Ensuring the application guidance is useful. The application guidance as drafted is too long and appears to repeat requirements rather than providing additional guidance on those requirements. We are also concerned that listing estimates that may be low or not low inherent risk will potentially cause conflict as some of the examples given will not always fall into the categories they are listed under for all entities. The number of 'low' risks in A72 compared to the number of 'not low' risks in A73 may reinforce the notion that there are always relatively more risks that are not low. In respect of this issue, therefore, we would welcome more guidance in the application material to help auditors and regulators understand the IAASB's thinking on categorizing risks.

- Addressing documentation appropriately. Documentation is a key element in audit quality but ED-540 does not really expand on the documentation requirements in the extant standard. Although the additional requirements will require documentation, this point is not addressed in the ED. More precise documentation requirements and application guidance to enable auditors to appropriately and proportionately explain the work they have performed should be included.

**Lack of professional skepticism/challenge of management's assumptions**

Our members found it useful to have additional focus on professional skepticism through the step back requirements and discussion of management bias. However, there was a view that the discussion of potential biases could be enhanced as this is a key issue in the exercise of professional skepticism. In addition, the documentation requirements in relation to these areas are unclear. We believe that documentation of how the auditor has exercised professional skepticism throughout the audit process is key to addressing the perception that auditors are not sufficiently skeptical and also in assisting auditors to ensure that sufficient professional skepticism has been exercised. While there's an argument to be made that consideration of documentation of professional skepticism could be addressed by a separate workstream, the central nature of management judgement within ED-540 suggests that the IAASB should provide further explanation of its thinking now within ED-540 by providing additional application material on this issue.

While ED-540 has partly addressed this area, it needs to go further in addressing documentation of professional skepticism and in providing guidance on management and auditor biases. CA ANZ's *Practical ways to improve the exercise and documentation of Professional Scepticism in an ISA Audit*[1] addresses documentation of professional skepticism.

**Lack of sufficient auditor attention to disclosures**

The requirements and application material in ED-540 in relation to auditing disclosures of accounting estimates appear very similar to the extant standard. If there is a perceived deficiency in ISA 540, we would expect that there would be new requirements or, if the requirements are sufficient, new application guidance to direct work effort in this area. As the material in ED-540 addressing disclosures is similar to ISA 540, we do not feel it will address the concern in this area. The requirements and guidance need to address not only disclosure of estimates contained in the financial statements but estimates which are only contained in the disclosures.

**Preferred approach**

In order for a revised ISA 540 to address the concerns raised, we recommend that the proposals in ED-540 be revised with a focus on:

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[1] https://www.charteredaccountantsanz.com/-/media/45b4a4db56b04f1f8a584ebde5860605.ashx

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- Scalability via an appropriate measure for identifying and assessing the risk of the estimate and subsequently driving the work effort. This may be using significant risk (to ensure the revised standard is consistent with ISA 315) or a combination of significant risk and other factors that impact risk of material misstatement to allow for further granularity in addressing estimates appropriately. Appropriate guidance will be needed in the application material to help practitioners apply ED-540 consistently in respect of all sizes of entity.

- Scalability via clear language in relation to the work effort in relation to each of the three factors – complexity, judgment and estimation uncertainty – if these are retained as separate elements. Also a clearer articulation of the auditor's ability to select the aspects of these elements that need to be addressed for a particular estimate and design appropriate procedures.

- Clearer documentation requirements and application material, particularly in relation to the exercise of professional skepticism and disclosures, in particular for estimates that are only contained within disclosures.

- More clarity in relation to auditor's ranges and point estimates, in particular when it is appropriate to use one as opposed to the other. The focus of the standard should be on how the auditor assesses management's estimate or range rather than developing their own range, as this will not always be possible. It is appropriate to include guidance on how the auditor needs to address the possibility of management bias when addressing the reasonableness of management's estimates to address concerns that auditors do not sufficiently challenge management.

- Refinement of the application material with a focus on providing guidance and some relevant examples to assist the auditor in applying the requirements.

Our responses to the specific questions raised in ED-540 follow in Appendix A.

## Appendix A: Response to request for specific comments

### Q1. Has ED-540 been appropriately updated to deal with evolving financial reporting frameworks as they relate to accounting estimates?

No. For the standard to adequately deal with estimates in future standards, it is important that it takes a principles-based and scalable approach. ED-540 as drafted is overly prescriptive and lacks scalability. These issues need to be addressed for the standard to be fit for purpose. It is also important that future accounting standards adequately address management's responsibilities in relation to estimates. ED-540 has requirements which put the auditor in the position of trying to compel management to perform certain responsibilities which is inappropriate. The IAASB should work with the IASB to ensure management's responsibilities for estimates are included in the relevant IASB standards.

ED-540 as drafted seems focused on financial services concepts and addressing the estimates that exist within IFRS 9 but does not seem to address the kinds of estimates that will be introduced or changed by other standards that will soon by applicable, including leases (IFRS 16), revenue recognition (IFRS15) and insurance contracts (IFRS 17).

In addition, the standard needs to be useful for auditors who in the future may be dealing with non-financial estimates and disclosures in emerging areas of reporting and assurance. For example, the ISAEs refer assurance practitioners to the ISAs for guidance on issues that are not dealt with specifically within assurance standards. As the ISAEs do not address estimates in detail, a practitioner would have to refer to ISA 540 for guidance.

### Q2. Do the requirements and application material of ED-540 appropriately reinforce the application of professional scepticism when auditing accounting estimates?

We are pleased to see an acknowledgement in paragraph 10(c) of ED-540 of the danger of anchoring bias to auditor decision-making. However, it is unclear to us that this section, and its supporting application material, is sufficient to fully mitigate the impact of the bias. For example, there is a fine balance between avoiding knowledge of the entity to mitigate anchoring bias and obtaining knowledge of the entity in order to make the auditor's assessment under paragraph 10(c) relevant. The application material does not help the auditor navigate these two positions.

ED-540 should make a stronger connection between the use of judgement by management and the extent to which that judgement might be affected by cognitive biases. Auditing standards require the auditor to be alert to indicators of management bias and to take mitigating action where it is identified. Academic research indicates that cognitive biases are subconscious and will always be present. Therefore it is important when auditing estimates to seek and obtain evidence of the extent to which management's use of judgement is affected by bias and whether this means balances and disclosures are materially misstated. ACCA's publication *Banishing Bias*[2] provides an analysis of the main cognitive biases and how they

[2] http://www.accaglobal.com/gb/en/technical-activities/technical-resources-search/2017/may/banishing-bias.html

might impact on the audit process. CA ANZ's *The Art of Professional Scepticism*[3] series also address biases.

We therefore believe that further guidance would be useful, particularly in relation to management/auditor biases and documentation.

**Q3. Is ED-540 sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk?**

No. As discussed in our general comments, we believe that the ED is not sufficiently scalable and will drive auditors to an increased work effort and a compliance driven approach to auditing estimates that will not address the concerns raised in relation to ISA 540. We have made some suggestions as to how the necessary scalability might be achieved in our overall comments and responses to Question 4.

**Q4 When inherent risk is not low:**

**(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?**

ED-540 introduces an either/or test of low or 'not low' inherent risk. The use of 'not-low' inherent risk does not allow for recognition of the existence of a scale of risk in relation to estimates. It will likely result in nearly all estimates being subject to the procedures in ED-540 which will significantly increase work effort without necessarily improving audit quality. The measure used to identify estimates which require additional work effort by the auditor needs to be more flexible and recognise the spectrum of risk that exists within estimates. We acknowledge the concerns that the use of significant risk in ISA 540 sets the bar too high but we believe that 'not-low' sets the bar too low. An either/or measure is not sufficiently flexible to achieve scalability and allow auditors to achieve an appropriate work effort to address the spectrum of estimates. We believe the measure used needs to be more sophisticated and based on risk of material misstatement and linked to the assertions the auditor is trying to address. It also needs to be consistent with the concepts in ISA 315 and ISA 330 to avoid confusion. There also needs to be a planned approach to incorporating changes to ISA 315 and 330 that are likely to arise from the revision project in relation to ISA 315 to maintain consistency with these standards.

As well as reconsidering the low/'not low' distinction, we believe the application guidance needs to be improved. Currently the paragraphs in A72 and A73 include examples of estimates that may are low or not low. Rather than take this approach, which again, may cause difficulty with regulators expecting the identified risks to always be low or not low, it would be more useful to have a matrix examples which show how a given estimate may be low or 'not low' (or may move along a scale of risk) depending on factors that impact the

[3] https://www.charteredaccountantsanz.com/member-services/technical/audit-and-assurance/professional-scepticism

estimation uncertainty, judgement, or complexity of that estimate for different entities. This kind of matrix would assist auditors in understanding when it would be appropriate to categorise estimates as low risk. If the application guidance retains lists of examples, it would be useful for there to be more equal numbers of examples of low and not low risks to avoid giving the impression that low risk estimates are uncommon.

We are unconvinced by the confidence with which ED-540 proposes the use of inherent risk. An auditor can only observe a single outcome, which represents the residual risk of inherent risk mitigated by actual controls. From this, the auditor, drawing upon their own experience, forms a view as to the likely residual risk or the likely inherent risk and control risk. There is a sense in ED-540 that this can be done more scientifically than is achievable in practice. While it is correct and important to discourage auditors from wrongly relying upon controls they have not tested, there is a concern that this will still happen because auditors will under-assess some risks. In addition, the lack of an objective basis for determining inherent risk may result in the auditor's judgment being challenged by regulators, who may be unfairly informed by hindsight. The concepts in ED-540 may also lead auditors to over-assess other risks, leading them to do work in areas that do not require it. Because the auditor is assessing the 'risk of material misstatement' (in accordance with ISA 315), we feel that more guidance on materiality would be useful.

ED-540 also lacks clarity around the concept of inherent risk being used. There is a difference between the inherent risk intrinsic to an estimate, which may not be able to be 'audited away' and the inherent risk that arises from a lack of precision in management's approach in applying the financial reporting framework.

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

As discussed in our overall comments, our members expressed a view that the separation of the factors is somewhat artificial. They view estimation uncertainty as the key determining factor with complexity and judgement and management bias feeding into the overall assessment of estimation uncertainty. While it is useful to prompt the auditor to consider the issues associated with each of these factors as set out in paragraphs 17-20, the wording in ED-540 does not provide scalability for the auditor to plan audit procedures to address the risk of material misstatement in relation to determining which of the aspects of the factors need to be addressed. There is concern that the language in paragraphs 17 to 19 may be interpreted by regulators as a need for auditors to design procedures to address all these issues in each of the three areas for every estimate, which forces a compliance mindset which may have negative consequences on audit quality.

It would be more useful for the auditor to consider estimation uncertainty, to have scalable requirements in relation to how the auditor addresses degrees of estimation uncertainty in their work effort. Application guidance could provide detail on how the factors of complexity, judgement and management bias may impact estimation uncertainty and what matters may need to be addressed in relation to each of those factors in the auditor's procedures. In particular, greater emphasis on 'judgement' and an explicit linking between judgement and management bias would be useful. We believe that it is vital for the auditor to understand management's motivations, incentives and biases in preparing estimates in order for them to appropriately audit the estimates. This is not addressed in paragraph 18, nor in the standback section in paragraphs 22-23.

**(c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17-19 of ED-540? If not, what additional guidance should be included?**

We do not support the inclusion of paragraphs 17-19 as drafted. For the standard to be scalable the wording in relation to the objectives-based requirements need to allow for exercise of professional judgement by the auditor as to which elements of the objectives need to be addressed for any given estimate assessed as having 'not-low' inherent risk. As discussed in our overall comments above there are strong concerns about the overly prescriptive work effort in each of the three areas. As currently drafted, we believe that the wording will drive auditors to try to address all the elements of each of the paragraphs which will not appropriate for all estimates. The standard needs to be flexible in the determination of work effort to allow the auditor to focus their procedures appropriately to address the risk of material misstatement and maintain audit quality.

**Q5. 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 540, in evaluating whether management's range is reasonable or misstated?**

We do not support the proposed requirements in this area. The concern in relation to auditor's ranges appears to be that auditors do not sufficiently narrow their ranges and therefore may accept an estimate from management that falls within the auditor's range but that is, in fact, not reasonable. As highlighted in ACCA's report *Banishing Bias*, auditors need to be aware of the risk of confirmation bias when undertaking the audit. This requirement to reduce the auditor's own cognitive bias is usually encapsulated within the concept 'professional scepticism'. It would be helpful to clarify within ED-540 the extent to which the auditor should challenge evidence which supports management's assertions and seek additional evidence, and the extent to which they can validate that management's assertions are reasonable. At the same time, it should be recognised that management will generally view their own supporting documentation as being more persuasive than any contradictory evidence supplied by the auditor, for the same reason.

The approach taken in ED-540 appears to put the onus on the auditor to develop their own range and estimates, as opposed to assessing whether the range or point estimate prepared by management is reasonable. While this may be the most efficient option for some estimates, this is not always the case. Given the highly complex nature of some estimates, it may not always be possible for the auditor to develop their own range or point estimates. Management is responsible for the preparation of the financial report and the estimates contained in the financial statements and disclosures. The auditor's responsibility is to obtain sufficient appropriate audit evidence that these are not materially misstated rather than re-perform the work of management. The auditor may decide that determining their own range is appropriate for some estimates but it should not be mandatory for all estimates. If the estimate is highly complex or management's work in determining the estimate is not sufficient, the auditor needs to consider the impact on their opinion, including modifications, or withdrawing from the engagement. This would be consistent with the approach taken in other standards to address a failure by management to fulfil their responsibilities.

Further, estimates that have a high degree of uncertainty will have a wide range of possible outcomes and no degree of audit effort can eliminate this. The standard needs to have to take a principles-based approach so that auditors can determine the appropriate response to the degree of uncertainty within an estimate.

The requirements and application material in ED-540 do not focus on assisting the auditor to appropriately narrow their range. We encourage the IAASB to focus on how to direct the auditor's work effort in relation to assessing the range/estimate used by management so that the auditor appropriately addresses concerns such as the potential for management bias, confirmation bias and other factors that give rise to the current concerns raised in relation to auditor's ranges. There needs to be guidance on when an auditor may use a point estimate versus a range. In addition, more information and guidance is necessary in relation to how materiality will impact these determinations. There also needs to be clear guidance on how the auditor documents this process, including documenting the justification for any revisions to the range or estimate. Consideration also needs to be given to the role that data analytics and other new tools may be used. As discussed in our overall comments above, it would be useful to clarify the definition of inherent risk and estimation uncertainty to those constrained by the financial reporting framework to allow the auditor to focus on the risks that they can address.

**Q6. Will the requirement in paragraph 23 and related application material (see paragraphs A2-3) and A142-A146 result in a more consistent determination of a misstatement, including when the auditor uses an auditor's range to evaluation management's point estimate?**

No. ED-540 does not distinguish between factual misstatements and judgmental misstatements and the different inherent issues with the two: for example, a judgmental misstatement may be more difficult to challenge. There is also little discussion around the consideration of disclosures in considering misstatements. ED-540 also lacks discussion of materiality which is key in the determination and evaluation of misstatements. Due to the challenging nature of the misstatements which may occur in relation to estimates, i.e. judgmental misstatements or disclosure misstatements, it would be appropriate for additional guidance in applying materiality to the audit of estimates. The focus of the requirements and application material appears to be on numerical calculation and determination where, due to the nature of estimates, an approach focused on the numbers does not account for all aspects of an estimate or the related disclosures.

**Q7 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 evaluation of the relevance and reliability of information from external sources?**

Auditors are required to consider the relevance and reliability of information obtained already, so we are uncertain that the requirement in relation to external information sources is useful. Application guidance is useful to assist the auditor in evaluating the relevance and reliability of the information however, again, the current application guidance provided is long and not focused. It is unclear what concern the amendments are addressing. We understand that ISA 500 will be revised in the near future, so the manner in which external information sources are addressed by that standard may be better addressed by a more considered approach during that project.

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