

1 August 2017

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Dear Sir,

**RESPONSE TO THE INTERNATIONAL AUDITING AND ASSURANCE STANDARDS BOARD (IAASB) EXPOSURE DRAFT (ED): ISA 540 (REVISED), *AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES***

To solicit meaningful feedback for this ED, the Institute of Singapore Chartered Accountants (ISCA) sought views from its members through a one-month public consultation process and discussed the ED with members of the ISCA Auditing and Assurance Standards Committee.

Our comments to selected questions in the ED are as follows:

**Overall Questions**

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

- 2.1 We agree with the IAASB that professional scepticism plays a pivotal role in the audit of management's accounting estimates.
- 2.2 While this fundamental principle is embedded within ED-540, its importance could be further emphasised with an additional focus at the start of the proposed standard. We recommend that the IAASB specifically highlight the importance of applying professional scepticism when auditing management's estimates. This includes maintaining an inquisitive and independent mindset to gather alternative audit evidence to corroborate with management's estimates.
- 2.3 Whilst one of the objectives of ED-540 is to reinforce professional scepticism, of which several key provisions are designed to set the intended tone and audit approach, more clarity could be provided regarding the extent of audit documentation required to demonstrate the application of professional scepticism.

## 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?
- 4) When inherent risk is not low (see paragraphs 13, 15 and 17–20):
  - a) Will these requirements support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to accounting estimates, together with the relevant requirements in ISA 315 (Revised) and ISA 330?
  - 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?
  - c) Is there sufficient guidance in relation to the proposed objectives-based requirements in paragraphs 17 to 19 of ED-540? If not, what additional guidance should be included?

### Use of inherent risk as the basis to direct work efforts in ED-540

- 3.1 ED-540 introduces a concept of using inherent risk as the basis to direct work efforts while ISA 330, *The Auditor's Responses to Assessed Risks* requires the auditor to design audit procedures in response to assessed risks of material misstatement and significant risks, with little mention of inherent risk. The apparent misalignment between the 2 standards might create unnecessary confusions.
- 3.2 In this respect, the IAASB may wish to relook into the 2 standards and align the auditor's responses to assessed risks, where necessary.
- 3.3 If the IAASB eventually concludes on the use of inherent risk to direct work efforts subsequent to further deliberation, more clarifications could be provided in the basis of conclusion to explain the decision. The concept of inherent risk should be consistently explained in both standards. We would like to highlight that this is a crucial step in the audit planning process as it will have broader implications on how auditors should assess significant risks and inherent risks.

### Risk assessment procedures and related activities

- 4.1 Paragraph 10 of ED-540 imposes a list of new requirements for the auditor to obtain an understanding of the entity and its environment, including its internal control, as part of its risk assessment procedures.
- 4.2 Instead of imposing additional requirements on top of those in extant ISA 315 (Revised) which is the foundational risk assessment standard, the IAASB could consider streamlining the requirements in both standards.
- 4.3 In addition, the IAASB could provide further guidance on the extent of documentation required for the auditor to demonstrate the work done on the requirements in paragraph 10 of ED-540.

### **Accounting estimates involving estimation uncertainty**

- 4.4 In executing audit procedures such as testing for goodwill impairment where a high level of estimation uncertainty is involved, it is unclear whether the assessment of the risk factors relating to estimation uncertainty should be influenced by whether the accounting estimate is eventually recognised in the financial statements. (Ref: Paragraph 10(c) of ED-540).
- 4.5 The key assumptions such as revenue and growth rates which involve a high level of judgement and estimation typically will not directly impact the entity's financial statements, unless an impairment loss is eventually recorded.
- 4.6 We are of the view that a high level of estimation uncertainty exists in such cases, even though the accounting estimate may not be eventually recognised in the financial statements. We seek the IAASB to provide further clarification and guidance in this area.
- 4.7 In addition, we recommend that a sensitivity analysis test could be introduced as part of a more robust risk assessment process. By performing sensitivity analysis at the planning stage, the auditor could zoom into identifying specific parameters such as discount rates as a specific risk area instead of impairment of goodwill as a whole. This will allow the auditor to effectively direct adequate work efforts in that identified risk area.

### **Responses to assessed risks of material misstatement**

- 4.8 Whilst the IAASB concluded in ED-540 that the 3 factors (complexity, judgement and estimation uncertainty) are likely to influence the risks of material misstatement in relation to making an accounting estimate, we are of the view that it may not be necessary to perform a risk assessment of these risk factors independently given that the factors are likely to interact and influence one another in practice.
- 4.9 As the new requirements in paragraphs 17 to 20 of ED-540 give the impression that these 3 factors should be assessed independently with distinct audit procedures to be carried out in response to individual factors, it appears that some of the requirements in paragraphs 17 to 20 of ED-540 overlap in certain aspects, for example, paragraphs 17(a) and 18(a)(i), and paragraphs 17(a) and 18(c).
- 4.10 In essence, we are concerned that the proposed new requirements to independently assess complexity and judgement will make the risk assessment process unduly complex while not substantially changing the underlying audit procedures performed to address the risk. This may introduce unwarranted complexities especially for the small and medium practices. Furthermore, we also noted that there is no significant difference in the key audit responses that will be carried out under ED-540 compared to the actual audit procedures that were performed under the extant ISA 540.
- 4.11 Instead of independently assessing the 3 factors, the auditor could consider assessing the entire estimation process holistically by examining the inputs, outputs, methodologies, assumptions and source data used. This appears to be a more objective process. Furthermore, qualitative factors including the factors of complexity, use of judgement by management and estimation uncertainty will also be considered as part of this process.

### **Retrospective review**

- 4.12 The IAASB could consider highlighting that a retrospective review could constitute both a risk assessment and substantive audit procedure.
- 4.13 More clarity and guidance could also be provided in ED-540 on the auditor's next steps, for instance, the nature and extent of further audit procedures to be performed following the outcome of the retrospective review.
- 4.14 In addition, the IAASB could clarify if paragraph 11 of ED-540 on retrospective review would apply in the following scenarios:
- estimates with low inherent risk;
  - estimates for which the outcome of the initial estimate may become known during the audit such as bonus accrual; and
  - where the auditor had already performed procedures in relation to paragraph 10(e)(vii) of ED-540 with a satisfactory conclusion on management's process over the need for a change in accounting estimates from the prior period

**5) Does the requirement in paragraph 20 (and related application material in paragraphs A128–A134) appropriately establish how the auditor's range should be developed? Will this approach be more effective than the approach of “narrowing the range”, as in extant ISA 540, in evaluating whether management's point estimate is reasonable or misstated?**

- 5.1 It may be beneficial to reiterate in ED-540 that in the event the auditor assesses that management has not appropriately understood or addressed estimation uncertainty, the auditor must apply professional scepticism and maintain full independence and objectivity in developing a point estimate or a range to evaluate the reasonableness of management's estimate uncertainty.
- 5.2 Additionally, ED-540 could also emphasise that in the event management does not have a robust internal controls process in making an accounting estimate, the auditor should consider the implications of the internal control deficiencies on other audit procedures and the audit as a whole.

### **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?**

- 7.1 With reference to paragraph A33C on the conforming amendments to ISA 500, the IAASB could clarify the circumstances which require an auditor to consider alternatives on external information sources, even if their clients use reputable external data sources such as Bloomberg to obtain SIBOR, inflation rate or risk-free rates to make an accounting estimate.

- 7.2 Furthermore, in practice, it might be challenging to perform additional work to verify the integrity other than quoting the source of data. For example, external valuation experts may use proprietary models or data sources to develop inputs, such as capitalisation rates and discount rates, in the valuation model. When management rely on external experts to perform independent valuations, it is difficult for auditors to obtain information to evaluate such inputs as they have no contractual relationship with these management's experts.
- 7.3 Guidance on the extent of documentation required would be useful especially when verification of the integrity of external information sources prove impracticable.

## Other Comments

### Clarity of scope

- 8.1 With reference to paragraph A75 of ED-540, it is unclear if, estimates for which the outcome is expected to be known, are within scope of this ED-540, and accordingly, if the requirements in paragraphs 10 and 15-20 of ED-540 would apply. One such example would be where the auditor obtains sufficient appropriate audit evidence for bonus accrual, referred to in paragraph A72, by vouching to actual payouts and the relevant supporting documents prior to audit report date.
- 8.2 In our view, the IAASB could enhance clarity by specifying in ED-540 that such estimates, for which the outcome is expected to be known during the audit, are not within the scope of the standard, since there is no element of estimation uncertainty.

### Subsequent events

- 9.1 The revised requirement in ED-540 paragraph 15(a)(i) relating to obtaining audit evidence about events occurring up to the date of the auditor's report appears to be an extended procedure on subsequent events. It is unclear if the IAASB's original intent was to expand the auditor's responsibility on subsequent events on accounting estimates.
- 9.2 To minimise confusion, we propose to retain the wordings in the extant ISA 540 paragraph 13(a) which requires the auditor to "determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate".

### Use of terminology

- 10.1 ED-540 paragraph 19(a)(i) requires the auditor to obtain sufficient appropriate audit evidence about whether, in the context of the applicable financial reporting framework, management has taken appropriate steps to understand and address the estimation uncertainty, and develop a point estimate that meets the measurement objective.

10.2 Practically, it may be challenging for the auditor to obtain sufficient appropriate audit evidence to demonstrate that management has indeed taken appropriate steps to understand and address the estimation uncertainty. Hence, we propose to use the term “consider” or “evaluate” rather than “to obtain sufficient appropriate audit evidence”.

**Effective Date**

11.1 We support the IAASB’s recommendation that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of the final ISA.

Should you require any further clarification, please feel free to contact Mr Kang Wai Geat, Deputy Director, Audit Quality & Standards Development, or Ms Zoey Xie, Manager, Audit Quality & Standards Development, at ISCA via email at [waigeat.kang@isca.org.sg](mailto:waigeat.kang@isca.org.sg) or [zoey.xie@isca.org.sg](mailto:zoey.xie@isca.org.sg) respectively.

Yours faithfully,



Ms Fann Kor  
Director  
Audit Quality & Standards Development, Continuing Professional Education and Industry Support