

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

Accounting estimates are an integral part of financial reporting, often accounting for a large proportion of financial statement line items. Many estimates are complex, involve a significant amount of judgement and they can include significant estimation uncertainty.

The AUASB is supportive of the intentions behind the IAASB's proposed revisions to ISA 540 and plan to improve audit quality by keeping the auditing and quality control standards relevant in the face of continually evolving business environments and pending accounting standard changes (in particular IFRS 9, 15 and 17).

The AUASB however raises several matters that are considered in more detail throughout the body of this response:

- bringing greater precision to an estimate that is inherently imprecise (refer response 5.1);
- scalability of the standard across different types and sizes of entities and accounting estimates (refer response 3 and 4);
- role of management vs auditor (refer response 2.2); and
- length and prescriptiveness of standard (refer response 2.3)

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

The AUASB considers that the application of professional scepticism is appropriately reinforced when auditing accounting estimates. While professional scepticism is a general concept that sits across the suite of auditing standards, owing to the nature and significance of this area, the AUASB is supportive that ED 540 does not explicitly reference professional skepticism but rather contains several key concepts that are designed to enhance the auditor's application of professional skepticism including more granular requirements with respect to obtaining audit evidence, indicators of bias and the stand back provisions.

2.1 Stand back provision

The IAASB has included concepts that appropriately aligns to and highlight the importance of the exercise of professional scepticism, particularly the inclusion of a stand back provision as introduced by paragraph 22, and considers that this requirement serves as a reminder to practitioners as to the importance of the exercise of professional scepticism in their overall assessment of accounting estimates and related disclosures.

While this stand-back provision is a new requirement of the standard, the AUASB considers that the requirement needs to be more explicit in its wording and call out exactly what the intention of the requirement is, that is, for auditors to stand-back and assess the estimate considering all supporting audit evidence. Additionally, the documentation requirement in paragraph 27 does not address the documentation requirements regarding this provision and there is a level of concern amongst practitioners regarding the extent of documentation that may be required. The AUASB recommends that the documentation requirement or guidance is expanded to address the nature and extent of documentation requirements in relation to the stand back provision.

2.2 Audit evidence as provided by management

In our view, the root cause of any perceived shortcomings in the application of professional scepticism in relation to accounting estimates and related disclosures may invariably be associated with inadequate documentation, calculation and models in relation to estimates that are provided to auditors by management and those charged with governance and accordingly

may not necessarily be addressed solely through the revision to auditing standards. Stakeholders are concerned that greater onus is being placed on the auditor than the preparer, and the standard appears to be heading down the path of expecting the auditor to develop a point estimate or range to evaluate reasonableness, for example paragraph A127. Where auditors proceed down the path of reperformance, this in turn limits the exercise of professional scepticism.

2.3 *Prescriptiveness and language of standard*

The AUASB considers that the standard, in particular the application material, is too verbose, and is becoming overly prescriptive and rules based leading potentially to a checklist mentality and accordingly perhaps a diminution of auditor's professional judgement and scepticism that may result in an unintended decline in audit quality.

Furthermore, the AUASB considers that the language in the standard could be strengthened to further promote the exercise of professional scepticism by being more focused on words that challenge and critically assess rather than corroborate, for example paragraph 19 where the auditor obtains sufficient appropriate audit evidence whether managements point estimate is reasonable. Additionally, the AUASB considers that the wording of the standard is in certain instances, taking the exercise of professional scepticism too far, for example, paragraph A101 indicates that the auditor should look to any other alternative.

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

The AUASB does not consider ED 540 to be sufficiently scalable with respect to auditing accounting estimates, including when there is low inherent risk. There is no explicit scalability in many of the requirements within the ED which may lead to uncertainty and the auditor undertaking an increased level of work effort across all estimates. Additionally, the AUASB raises concern as to the practicality of how this would work outside significantly large and complex sectors and industries, as well as posing significant practical challenges particularly for mid-tier and smaller practitioners. To avoid overcomplicating the audit response for simple, straight forward estimates, we suggest the requirements and application material are described in a better way some examples of which are in the paragraphs below.

3.1 *Concept of low inherent risk*

The introduction of the term low "inherent risk" is problematic, given the lack of definition or parameters around what constitutes a low inherent risk as well as the disconnect to ISA 315 where risk of material misstatement is what determines nature, extent and timing of audit effort. The AUASB is concerned around the scalability of the standard being determined by an assessment of inherent risk alone without the consideration of control risk and considers that this may drive a significant uplift in audit effort. ISA 200 determines that the assessment of the risk of material misstatement can be completed as a combined or separate assessment of both controls and inherent risk. The ED is based on a separate assessment, it is not clear how practically, practitioners that perform combined risk assessments when determining the extent of audit effort, will be impacted and potentially for these practitioners, scoping based on inherent risk alone appears contrary to common practice.

The AUASB considers that the risk of material misstatement is what should drive scalability rather than inherent risk in isolation. The AUASB considers that, while the intention of scalability is apparent in the standard, there is not sufficiently flexibility in the requirements and accordingly the AUASB are concerned that practitioners will be auditing estimates because of a checklist mentality and not because of real risk of material misstatement.

3.2 *Examples of low inherent risk*

Estimates by their nature are judgmental, and based on the examples given in paragraph A72, it would appear that all but the simplest of estimates would have an inherent risk other than low associated with it. To this end, it is arguable that almost all estimates would have an inherent risk greater than low. If this is not the IAASB's intention, then to alleviate such concerns, the IAASB could consider providing more extensive examples as to types of estimates that may be considered to have a low inherent risk associated with it, for example employee leave provisions.

However, there is a risk associated with including examples in this context in that this may reduce the degree of professional judgement that can be applied. It may be difficult for practitioners to justify a low inherent risk classification for items given as examples in the standard.

Q4: *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?

The AUASB is supportive of the use of these concepts in the standard, however it is currently unclear whether these concepts are 3 independent constructs or whether they are assessed as a whole and accordingly the level of flexibility afforded to auditors in the design of their audit procedures is unclear. For this reason, we don't believe that there is adequate clarity on helping the auditor answer the key question of "how much is enough".

The current construct of Paragraph 15(b) does not make this point sufficiently clear and paragraph A97 adds further confusion. Furthermore, the AUASB considers that the requirements and application material of this standard is becoming overly prescriptive which may result in a rules-based checklist mentality and diminished exercise of auditor's professional judgement.

4.1 *Scalability*

When inherent risk is not considered to be low, it is likely that some estimates will fit into all 3 categories (complexity, judgement, estimation uncertainty), which we don't believe was the intention of the revised standard. This may lead to confusion as to the extent of audit effort, may limit the exercise of professional judgement and again may be an impediment to achieving scalability.

Stakeholders consistently commented that it is complexity and judgment that drive estimation uncertainty and therefore estimation uncertainty could not be considered as a factor in isolation. Additionally, it was regarded as problematic to compartmentalise judgement and estimation uncertainty, and accordingly stakeholders did not support the categorisation of estimates into the 3 factors. Furthermore, audit procedures undertaken by auditors generally cross categories and accordingly such categorisation may lead to a checklist based approach which may be seen as a limitation to the IAASB objective of scalability (refer to Question 3).

4.2 Complexity

The AUASB considers that additional factors as to what constitutes complexity needs to be addressed within the standard, as complexity is a relativity concept, that is not only impacted by the estimate itself, but also by the composition of the audit team and skill set of management. Additional guidance is required in this area and the lack of guidance is highlighted by the consideration of complexity having 6 associated application paragraphs, while judgment and estimation uncertainty have over 20 paragraphs of application material.

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?

The AUASB has a mixed response to this question, and notes that in some areas, the guidance is too lengthy while in other areas, guidance is seen as lacking.

4.3 Overall comments on application material

While improved and additional application material may be beneficial, the AUASB considers that the standard, including the application material, is too verbose, and is becoming overly prescriptive and rules based leading to diminution of auditor's professional judgement. Additionally, the language and layout of the application material is tending to be background and informative in nature as compared with what we expect application material to constitute, that being, practical examples and other explanatory details and procedures that are included for the purposes of understanding, and complying with, mandatory requirements. To this end, it is becoming difficult to extract the true guidance from the for information/background only material. This background information should be removed from the application material and included in appendices, for example appendix 2.

Furthermore, the AUASB considers that the supplement that was issued by the IAASB to the ED, *Illustration of work effort requirements*, to be beneficial in understanding the flow of the standard, and accordingly deems it appropriate that the diagram is included as an appendix to the standard.

Q5 and Q6: 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.

Will the requirement in paragraph 23 and related application material (see paragraphs A2–A3 and A142–A146) result in more consistent determination of a misstatement, including when the auditor uses an auditor's range to evaluate management's point estimate?

The AUASB considers that the requirement in paragraph 20 with the associated guidance, appropriately establishes how the auditor's range should be developed and is more effective than the current approach of narrowing the range. However, the AUASB considers that further guidance is required to clarify the expectations of when an auditor's range should be developed and how that range is utilised in evaluating management's point estimate. The AUASB does not consider the requirement in paragraph 23 with the associated guidance to be appropriate to result in a more consistent determination of a misstatement.

5.1 Ranges exceeding materiality

It is not clear whether the ED is introducing the concept that all ranges need to be within materiality – which for many estimates would not be possible. Many estimates are complex,

involve a significant amount of judgement and they can include significant estimation uncertainty. In some circumstances, the estimation uncertainty can lead to a range of possible outcomes that can be many multiples of materiality. In reality, it is not possible to bring greater precision to an estimate that is inherently imprecise under the applicable financial reporting framework.

In the ED, this appears to be addressed in paragraph 20(b) where “other requirements of the applicable financial reporting framework” can be read as referring to materiality. This reference diminishes the exercise of auditor’s professional scepticism and professional judgement and may well stem from regulator concerns regarding how auditors are using auditor’s professional scepticism and professional judgement in the establishment of their ranges and thresholds and holding to them consistently. In practice it is unlikely that ranges set are always within materiality especially as management’s or auditor’s experts engaged by auditors or management (e.g. valuers) do not take materiality into consideration when they set their ranges. The AUASB considers that the standard requires clarity where ranges exceed materiality and application material could be expanded to address types of considerations auditors use in the establishment of setting ranges and thresholds and mechanisms through which an auditor documents and reconsiders those thresholds in the conduct of the audit.

5.2 *Substantive analytical procedure*

Paragraph A128 deems that where an auditor develops a point estimate or uses an auditor’s range, the auditor is performing a substantive analytical procedure for which ISA 520 is the reference point for further audit requirements. The AUASB identifies that practitioners do not deem their development of a point estimate or range to be a substantive analytical procedure but rather a hybrid of test of detail and substantive analytical procedure, which this exposure draft does not address, (for example when testing derivatives a sample would be tested through independently determining a point estimate or reasonable range). Furthermore, the AUASB suggests that there could be a “hierarchy” built into the standard to guide auditors on when the use of a point estimate or range is most appropriate.

5.3 *Misstatements*

The AUASB considers that the determination of materiality is still open to interpretation and has not been sufficiently considered within the ED. The AUASB considers that a greater volume of principle based examples would be helpful in the application material or within an Appendix on the use of the point estimate or range and how misstatements are calculated. Visual examples of how the range applies in paragraph A145 could be beneficial.

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 evaluations of the relevance and reliability of information from external information sources?

The AUASB is largely supportive of the proposed conforming and consequential amendments to ISA 500 regarding external information sources and considers the proposed amendments to the requirements of ISA 500 to be clear.

However, the AUASB notes that the wide applicability to all standards needs to be carefully considered as in practice this may result in significantly more audit effort than before, as an example, reference to ISAE 3402 type reports. Furthermore, additional application material may be required in ISA 500 as to the extent of audit work required to understand the process in gathering information used in external information sources and may potentially lead to more assurance reporting on controls at service organisations.

In addition, the AUASB considers that more guidance is required where management and the auditor use the same information source. The AUASB currently considers the guidance contained in paragraph A33H to be unclear, particularly where there is only one provider of certain information.

Q8: In addition to the requests for specific comments above, the IAASB is also seeking comments on the matters set out below:

- (a) **Translations—Recognizing that many respondents may intend to translate the final ISA for adoption in their own environments, the IAASB welcomes comment on potential translation issues respondents note in reviewing the ED-540.**

Not applicable to the AUASB – no further comments.

- (b) **Effective Date—Recognizing that ED-540 is a substantive revision, and given the need for national due process and translation, as applicable, the IAASB believes that an appropriate effective date for the standard would be for financial reporting periods ending approximately 18 months after the approval of a final ISA. Earlier application would be permitted and encouraged. The IAASB welcomes comments on whether this would provide a sufficient period to support effective implementation of the ISA.**

The AUASB supports an effective date of financial reporting periods ending approximately 18 months after the approval of a final ISA with earlier application permitted and encouraged.