

Mr Arnold Schilder
Chairman
International Auditing and Assurance
Standards Board (IAASB)
529 Fifth Avenue 6th Floor
New York, NY 100017
United States of America

Ref: Proposed International Standard on Auditing 540 (Revised) - Auditing Accounting Estimates and Related Disclosures

Dear Mr Schilder,

RESTE ARNOLD,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to comment on the International Auditing and Assurance Standards Board's (IAASB) Exposure Draft: *Proposed International Standard on Auditing 540 (Revised) – Auditing Accounting Estimates and Related Disclosures* (thereafter “ED”). The views expressed in this letter are made with the objective of enhancing investor protection as well as market efficiency, integrity and transparency through ensuring high quality financial reporting.

ESMA welcomes the IAASB's efforts to address in the ED the consequences of the evolution of the financial reporting framework on the audit of accounting estimates. ESMA has previously argued¹ that the IAASB should address the relevant application issues in relation to the audit of accounting estimates. Over the last decade, financial reporting frameworks have progressively increased the importance of unbiased, comprehensive and clear disclosures on assumptions and judgments made by management when developing accounting estimates. Furthermore, ESMA notes that the recent accounting standards such as IFRS 9 *Financial Instruments* and IFRS 17 *Insurance Contracts* increase significantly the use of, and the reliance on management judgement when making accounting estimates, often requiring long forecast periods and reliance on complex modelling.

Consequently, ESMA strongly believes that audit standard setters need to consider these developments and ensure comprehensive and rigorous audit requirements for accounting estimates and the underlying judgements made by management. Furthermore, ISA 540 (Revised) should include requirements on audit of disclosures on these estimates and judgements as well as on appropriate documentation of the audit procedures performed. ESMA believes that the requirements of the ED represent an important step into the right

¹ ESMA comment letter to the IAASB Invitation to Comment: *Enhancing Audit Quality in the Public Interest: A focus on Professional Scepticism, Quality Control and Group Audits*, May 2016, ESMA/2016/728

direction and have the potential to improve audit quality. However, ESMA is of the view that ISA 540 (Revised) should include specific provisions on audit of selected accounting estimates, such as those made when auditing expected credit losses (ECL), fair value measurement or goodwill impairment. With respect to the newly introduced ECL model, ESMA calls on the IAASB to scrutinise carefully issues arising from auditing of the new ECL model, and, if necessary, provide additional guidance on a timely basis as a matter of priority. Detailed scrutiny is especially relevant for the implementation and auditing of complex ECL models, e.g. in the financial sector.

ESMA is of the view that the ED can be improved regarding the balance between the requirements and the application guidance, which do not have the same authoritative status. We are of the view that part of the application guidance should be transformed into binding requirements in order to ensure that the relevant provisions can be applied and enforced consistently. At the same time, ESMA is of the view that the application guidance should be as clear and concise as possible and therefore should avoid to the extent possible unnecessary repetition. Examples of both type of provisions are included in the Appendix to this letter.

Furthermore, ESMA would like to highlight a number of areas where further development of the auditing framework is necessary to ensure proper audit of accounting estimates, notably from an investor protection perspective:

- application of professional scepticism
- assessment and evaluation of management bias
- testing of effectiveness of internal controls
- response to the risk of material misstatement
- audit documentation
- interaction with key audit matters.

Finally, ESMA would like to ask the IAASB to finalise the revised standard on auditing of accounting estimates on a timely basis. In our view, the IAASB should enable and promote early application of the standard after its publication and facilitate the audit of ECL requirements, which are applicable from 1 January 2018.

Details on our suggestions where the framework for audit of accounting estimates could be further developed, together with our comments on some of the questions from the ED are set out in the Appendix to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

A handwritten signature in blue ink, appearing to be 'S. Maijor', written over a horizontal line.

Steven Maijor

Appendix – ESMA’s comments on the specific parts of the ED

Scope of application (Q1 of the Request for comments)

1. ESMA welcomes that the proposed requirements in the ED are applicable to the audit of all accounting estimates for all entities. ESMA highlights that the auditing of specific accounting estimates based on forward-looking information, long-term forecasting or projection has raised issues in the past. This has been particularly the case when auditing impairment of goodwill, recognition and measurement of deferred tax assets arising from the tax losses carried forward or determination of the fair value that rely on third-party pricing services or unobservable inputs (such as when using the discounting cash flow method). ESMA therefore believes that the current revision of the standard for auditing of accounting estimates should specifically address these issues.
2. ESMA acknowledges that use of forward-looking information will become more complex under the new accounting standards, notably for the financial sector. In this context, we would like to express our serious concerns on whether the proposed requirements are sufficiently specific to ensure effective audit of complex models led by the introduction of expected credit loss (ECL) models for impairment of financial assets in IFRS 9 or valuation of insurance liabilities at their fulfilment value in IFRS 17. Accordingly, in our view, the audit of the application of the ECL model might require specific guidance, notably with respect to the testing of effectiveness of controls and to the governance over the modelling and validation processes.

Specificity of the standard with regards to audit of ECL (Q1 of the Request for comments)

3. ESMA notes that the IAASB previously considered addressing some specific issues related to the audit of financial institutions in a separate International Auditing Practice Note (IAPN #1).² ESMA prefers that all requirements and application guidance specifically targeted to audit of accounting estimates stemming from ECL models for all entities are provided in ISA 540 (Revised). This reasoning applies equally to the audit of fair value measurement that rely on third-party pricing services. Currently the ISAs include discussion on pricing services in IAPN 1000, *Special Considerations in Auditing Financial Instruments*. ESMA is of the view that the IAASB should include in ISA 540 (Revised) the requirements on using of third-party pricing services when auditing assumptions used while determining fair values.
4. Consequently, ESMA recommends that the IAASB re-evaluates its decision and provides specific requirements on audit of ECL directly in ISA 540 (Revised), including any specific considerations relevant for audit of specific types of complex organisations, such as financial institutions or audit of fair value measurement relying on external pricing services.

² According to the IAASB work plan for 2017 – 2018 International Auditing Practice Note #1 is intended to address the auditor’s relationship with financial institution supervisory authorities, such as is common in the banking and insurance industries

5. ESMA accepts that the provisioning under the new ECL model and auditing of these estimates under ISA 540 (Revised) might raise a number of implementation issues and challenges. Therefore, ESMA calls on the IAASB to scrutinise carefully any issues arising from the audit of the new ECL model; this is especially relevant in cases of complex ECL models' audits, such as in the financial sector. ESMA strongly believes that as part of its implementation monitoring, the IAASB should be prepared to provide, if necessary, additional guidance on a timely basis and as a matter of priority. Such guidance might be in form of amendments to ISA 540 (Revised) or other additional guidance depending on the questions that might arise after the implementation of the new standard.

Key concepts and objectives of the standard (Q1 of the Request for comments)

6. ESMA believes that the objective of the ISA 540 (Revised) should not be merely "focusing auditors attention on design and performing further audit procedures responsive to reasons for the assessment given to the assessed risks of material misstatement" (paragraph 4 of the ED). Instead, it should also explicitly refer to the determination of the key methodological issues/procedures in the audit of accounting estimates. In this respect, ISA 540 (Revised) should require sufficient work effort on audit of accounting estimates in order for the auditor to be able to formulate an opinion in the audit report and evaluate whether accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. This reasoning applies equally to audit documentation. Furthermore, the audit procedures identified by the ED should cross-refer to the appropriate audit procedure requirements in other ISAs and be accompanied by specific guidance for audit of accounting estimates where appropriate.
7. While ESMA agrees with the proposed objectives of the work of the auditor, we are of the view that the objectives should explicitly require the auditor to evaluate whether management has made all the estimates necessary by the financial reporting framework in the specific circumstances of the reporting entity.

Scope and nature of the application guidance (Q1 of the Request for comments)

8. ESMA welcomes the IAASB willingness to provide sufficient application guidance for the requirements of the ISA 540 (Revised). However, ESMA is of the view that the ED does not strike the right balance between the requirements of the standard and its application guidance, which do not have the same authoritative status. Notably ESMA believes that part of the application guidance should be transformed into binding requirements in order to ensure that the provisions are applied consistently.
9. This is for example the case with regards to the application guidance related to the need to consider whether the auditor has obtained sufficient understanding of the entity and its environment in order to identify and assess the risks of material misstatement and to plan further audit procedures (paragraph A9 of the ED) and the enumeration of the cases when auditors may not rely on substantive testing alone (paragraph A98 of the ED). Further examples are included in a specific section of this letter.

10. On the other hand, the application guidance should be clear and avoid repetition to the extent possible. In this context, ESMA encourages the IAASB to review further the drafting of the application guidance in order to ensure clarity and readability of the text and where possible avoid unnecessary repetition.
11. For example, the IAASB could consider whether, when referring to other ISAs a cross-reference is sufficient when no new guidance specific to audit of accounting estimates is provided in ISA 540 (Revised). This might be the case e.g. in paragraphs A10-A11 of the ED in relation to ISA 260 - *Communication with Those Charged with Governance* and ISA 315 - *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, paragraph A76 in relation to ISA 315 and paragraphs A67, A70 and A94-A96 of the ED in relation to a number of ISAs. Furthermore, in some cases the application guidance refers only to basic procedures without sufficient level of specification. In these cases, it could be considered either to simplify the guidance or provide guidance more adapted to the level of complexity of the audit of accounting estimates. This might be the case e.g. when referring to basic accounting or auditing procedures in paragraphs A26-A29, A32 and A117-122 of the ED.
12. Finally, while we welcome that the IAASB decided to provide some specific examples on audit of ECL in the application guidance, we would prefer that the standard includes more specific considerations for auditing of estimates related to ECL. Furthermore, ESMA is of the view that the examples provided in the application guidance should not lead to an overly narrow interpretation of the requirements. Consequently, while ESMA appreciates the example in paragraph A73 of the ED that considers accounting estimate of an ECL model in a financial institution as an example of an estimate where the inherent risk is not low, ESMA doubts that this example should be limited only to ECL models of financial institutions that are active in different markets. Indeed, ESMA is of the view that the example applies to all financial institutions.

Role of professional scepticism (Q2 of the Request for comments)

13. ESMA welcomes that the proposed requirements highlight the role for the professional scepticism applied by the auditors when auditing accounting estimates. However, ESMA believes that the IAASB should emphasise further the need for rigorous application of professional scepticism throughout ISA 540 (Revised) requires gathering sufficient level of evidence to support the judgments and its proper documentation.
14. While ESMA acknowledges that the IAASB has a separate project dedicated to the enhancement of professional scepticism as part of the audit, ESMA is of the view that further requirements might be necessary to strengthen and document the use of professional scepticism in the context of ISA 540 (Revised). This is particularly the case when auditing accounting estimates for balances for which the inherent risk is not low. As these specific considerations might need to be considered comprehensively in that separate project, ESMA is of the view that the IAASB should finalise that separate project as a matter of priority.

Proportionality and scalability (Q3 of the Request for comments)

15. ESMA acknowledges that proportionality and scalability need to be able to address specific considerations related to audit of smaller or simpler entities, such as lack of segregation of duties and management override of controls. Furthermore, ESMA recognises that ISA 540 (Revised) should not be scalable only in one direction. On the contrary, it should highlight that for entities where the risks of material misstatement is exceptionally high (e.g. due to particular risk of management bias or because of their complexity) additional procedures would need to be required in order to achieve sufficient level of assurance for the audit of accounting estimates. Such requirements might be linked e.g. to the obligatory need to test effectiveness of internal controls for certain complex entities (see also paragraphs 24-25 of this letter).
16. ESMA highlights that from securities regulators perspective, consistent high-level audit requirements should be required for audits of similar underlying economic transactions in comparable types of entities. While considering proportionality, all entities with securities listed on a regulated market should be governed by the same (high) auditing standards.

Management bias

17. ESMA welcomes that the discussion on the risk of management bias when auditing accounting estimates is included in the application guidance. As we believe that the risk of management bias related to accounting estimates should be embedded into the auditors' work during the whole audit process, we believe that the result of the assessment and evaluation of the management bias should be included in the on-going communication with those charged with governance. Furthermore, where appropriate, due to significant risk of material misstatement, results of such evaluation should be included as a key audit matter in the auditor's report.
18. Consequently, we are of the view that the notion of management bias should be incorporated throughout ISA 540 (Revised). This could be done e.g. through clarification that the definition of reasonable in paragraph A2 of the ED should include an attribute being "free from bias", specifying that assumptions, as referred to in paragraph A32 of the ED, should be "free from bias" and including evaluation of management bias as one of the consideration required in paragraph A33 of the ED.
19. Furthermore, ESMA believes that the guidance on the assessment of management bias in paragraph A7 of the ED should be explicitly linked to the assessment of the outcome of an accounting estimate. Finally, ESMA is of the view that the ED could include additional examples on specific considerations pertinent to the evaluation of the management bias linked to auditing accounting estimates, e.g. related to ECL models, recognition and measurement of deferred taxes as well as goodwill impairment.

Risk assessment (Q4-Q6 of the Request for comments)

20. The ED proposes a different risk model for risk assessment related to audit of accounting estimates compared to extant ISA 315. While ISA 315 broadly distinguishes between significant and non-significant risks, the ED acknowledges low inherent risk and non-low inherent risk in addition to significant risk. In our view, the ED does not describe and explain clearly and unequivocally (i) the risk level not being low and (ii) significant risk(s) and does not explain the relation between them. Consequently, ESMA encourages the IAASB to clarify further the risk model in the ED and its relation to the existing requirements of ISA 315.
21. ESMA agrees with the proposed risk assessment procedures and related activities in paragraph 10 of the ED. However, ESMA believes that the IAASB should consider that understanding of risk and related internal control related to (i) the preparation of accounting estimates and related disclosures by management as required by the respective financial reporting framework and (ii) the completeness of the estimates made by management should be explicitly considered as part of the understanding of the entity and its environment.
22. ESMA emphasises the importance of using specialised skills when auditing accounting estimates, notably when those estimates rely on complex modelling. Therefore, we welcome the requirement that the auditor needs to determine early in the audit process whether specialised skills or knowledge are required, in order to perform the risk assessment procedures, or to identify and assess the risks of material misstatement. However, we are of the view, that the importance of the use of specialised skills and knowledge should be highlighted in all phases of the audit of accounting estimates not only as part of the risk assessment. Use of specialised skills might be indispensable also during the planning stage, during performing testing of controls or substantive testing, notably in complex environment.

Factors taken into account in identifying and assessing the risk of material misstatement (Q4-Q6 of the Request for comments)

23. ESMA agrees that complexity, management judgment and estimation uncertainty are principal factors to be taken into account in identifying and assessing the risk of material misstatement. However, ESMA is of the view that the level of estimation uncertainty represents the first element to be taken into account when identifying and assessing the risk of material misstatement, e.g. in case of reliance on forward-looking information. Consequently, we are of the view that this thought process should be reflected in the structure of the standard that should start with the level of estimation uncertainty, continue with the management judgement before considering complexity. ESMA also notes that the order of factors is different in the body of the standard and in Appendix 2 of the ED.

Testing of effectiveness of internal controls (Q4 and Q6 of the Request for comments)

24. ESMA welcomes the application guidance in the ED on the testing of effectiveness of internal controls over the accounting estimates and over the process of their preparation. In order to ensure that the auditors are required to test internal controls over the ECL in all appropriate circumstances (such as for financial institutions), guidance currently proposed for paragraph A98 should be further expanded and incorporated in the requirements section of the standard.
25. ESMA also believes that the importance of the testing of internal controls over the accounting estimates should be highlighted when performing procedures related to risk assessment and responses to the assessed risk of material misstatement. In reference to the latter, ESMA suggests that the relevant guidance in paragraphs A48-A60 of the ED related to auditor obtaining an understanding of internal controls (paragraph 10(f) of the ED) could be linked and emphasised in the requirements related to the auditor responses to the assessed risk of material misstatement (notably to paragraph 16 of the ED).

Responses to the assessed risks of material misstatement (Q4-Q6 of the Request for comments)

26. ESMA is of the view that the structure of the requirements in the paragraphs 14-20 of the ED could be improved by more clearly addressing the two situations in paragraph 15 (i.e. specifically identifying audit procedures to be performed (a) when inherent risk is low and (b) when inherent risk is not low). Furthermore, paragraph 15(a) could explicitly require an auditor to assess whether previous audit procedures performed provide sufficient appropriate audit evidence, when inherent risk is low.
27. While ESMA agrees with the matters of which the auditor needs to obtain audit evidence (paragraphs 17- 20 of the ED), we are of the view that they do not give an answer to the question what is sufficient appropriate audit evidence regarding cases with complexity, judgement or estimation uncertainty. We are of the view that specific audit procedures or specific practical guidance should be added to the application guidance.
28. ESMA is of the view that paragraph 18(c)(ii) that requires the auditor to obtain sufficient appropriate audit evidence on whether changes from the previous period's model are appropriate in the circumstances should be clarified. In particular, the guidance should address separately changes in the model and changes in the outcome of the model. Furthermore, the auditor should be required to obtain sufficient appropriate audit evidence when assessing reasons for a significant change in the model or a significant difference in the accounting estimate as well as in situations when there is a significant change in circumstances but no significant change in related accounting estimate.
29. Furthermore, ESMA is of the view that the application guidance in paragraph A126 should be turned into requirement in paragraph 19(b). Consequently, when in the auditor's judgment, management has not appropriately understood and addressed the estimation

uncertainty; the auditor should request management to consider alternative assumptions or to provide additional disclosure relating to the estimation uncertainty, before developing its own estimate. At the same time, in our view, the IAASB should explicitly address the consequences of the auditors' assessment that management has not appropriately understood and addressed the estimation uncertainty on the audit opinion and on reporting of key audit matters.

30. ESMA is of the view that evaluation of estimation uncertainty needs to be specified by (i) further clarifying paragraph A129 of the ED with regards to circumstances when it is appropriate to develop an auditor's point estimate and when a range and (ii) providing additional application guidance how the criteria in paragraph 20 of the ED could be met.
31. Finally, in our view, given that the accounting estimates are often subject to significant management judgement, the standard should include a separate requirement of obtaining relevant management's documentation regarding accounting estimates as part of obtaining sufficient appropriate audit evidence. Subsequently, taking into account the documentation received from management an auditor shall assess the appropriateness of an accounting estimate and conclude on its impact on the overall audit.

Audit documentation

32. ESMA is disappointed that the requirements related to the documentation of the auditing of accounting estimates do not seem to be sufficiently developed in the ED. ESMA is of the view that it would be appropriate to expand and define the documentation requirements included in the paragraph 27 of the ED as well as cross-refer them to the requirements of paragraphs 8 and A10 of ISA 230 - *Audit Documentation*. While ESMA does not support repetition of the requirements of other auditing standards, ESMA is of the view that the IAASB should consider transforming the relevant part of the application guidance specifically related to documentation of the audit of accounting estimates currently included in paragraph A158 into requirements within paragraph 27 of the ED.
33. We are of the view that estimation uncertainty, use of judgement and complexity of accounting estimates warrant additional documentation of the work of the auditors in this area than currently proposed by the ED. While we agree with the general intention of paragraph 27 of the ED, ESMA is concerned that the requirement of paragraph 27(a) of the ED is not sufficiently specific to ensure documentation of all substantial judgements and procedures when auditing this complex and judgemental area of financial reporting.
34. Therefore, ESMA suggests that the auditor should be required to document, with regards to all significant accounting estimates, as a minimum:
 - a. the basis for the auditor's conclusions on the reasonableness of areas of subjective judgement (as included in paragraph 27(a) of the ED);
 - b. assessment and evaluation of the accounting estimates, including their specific risk factors;

- c. significant judgements made by the auditor when assessing the accounting estimates;
- d. how professional scepticism in auditing accounting estimates was ensured; and
- e. assessment and evaluation of the factors driving potential risks related to the accounting estimates.

ESMA is of the view that specific requirements for audit documentation of accounting estimates in ISA 540 (Revised) would specify the generic requirements in paragraph 32 of ISA 315.

35. Finally, ESMA notes that the documentation requirements should be extended by specific requirements related to the documentation of the identification and assessment of the risk of material misstatement in relation to the accounting estimates by the auditor. This is because in our view, the reference to ISA 315 in paragraph 13 of the ED seems to be overly restrictive and might not capture documenting auditors' identification and assessment of the individual relevant factors, which the accounting estimate is subject to. In our view, such documentation requirement is even more relevant when the auditor assesses the inherent risk of misstatement as low.

Key audit matters

36. ESMA appreciates the reference to the link between certain aspects of the audit of accounting estimates related to estimation uncertainty and the key audit matters in paragraph A125 of the ED. However, ESMA strongly believes that the interaction between the audit of accounting estimates (and notably the auditor work on assessment of its elements of estimation uncertainty, management judgement and complexity) and key audit matters should be further developed in the requirements section of ISA 540 (Revised).

Disclosures

37. ESMA welcomes the requirements of paragraph 21 on the audit of disclosures related to accounting estimates. ESMA highly appreciates the requirements of paragraph 21(a) and strongly supports the requirement that the auditor should evaluate whether the management has provided all the disclosures that not only meet the objective of the disclosure requirements but also ensure fair presentation of the financial statements as a whole. However, ESMA is of the view that this requirement could be better explained (e.g. by building on the description provided in paragraph A120 that seems to be more clear and explicit as the requirements) and further exemplified in the application guidance.

Effective date (Q8(b) of the Request for comments)

38. While the impetus for revising the requirements for audit of accounting estimates is not limited to audit of ECL models, ESMA highlights the benefits of aligning the date of application of the new ISA 540 (Revised) and IFRS 9 to the extent possible. In this respect, ESMA regrets that full alignment is no longer possible given the mandatory effective date

of IFRS 9. Consequently, ESMA believes that the IAASB should do its utmost to finalise a high-quality and comprehensive standard for auditing accounting estimates (including any specific guidance for financial institutions) in time that it could be early adopted for the audit of the first set of annual financial statements in which IFRS 9 is applied.

Other comments

39. ESMA is of the view that paragraph 3(c)(ii) of the ED should be split into two separate considerations one focusing on management point estimate and one on disclosure. In our view it remains unclear why the IAASB decided to combine these two factors, as the susceptibility to misstatement with respect to estimation uncertainty may increase because of each these factors independently.
40. The term “outcome” defined in paragraph 9(f) of the ED should be used consistently throughout the standard. In this respect, the IAASB should distinguish whether the term outcome refers to the ultimate cash flows resulting from the estimate or to the final calculation of the amount, which was estimated.
41. While ESMA accepts the use of the term “reasonable” for the audit of disclosures related to accounting estimates for the reasons included in paragraph 11 of the explanatory memorandum to ISA 540 (Revised), ESMA is of the view that the explanation of the term in relation to the audit of disclosures should be included directly in ISA 540 (Revised).

Q7 of the Request for comments:

42. While ESMA welcomes the confirming amendments to paragraph 7 of ISA 500 – *Audit Evidence* addressing information obtained from an external source, ESMA notes that the requirements are disproportionately limited in comparison with the substantive body of the application material. ESMA suggest that those parts of the application guidance that constitute requirements are moved to the requirement section of ISA 540 (Revised).
43. Finally, we believe it would be inappropriate to limit external information sources to the information that is available to the public as proposed in paragraph A1A of ISA 500. We are of the view that such wording might be understood as limiting the scope only to “free and open data”. ESMA notes that external information sources are often not available to public, but only to certain users who often need to pay for such services (e.g. external pricing services or credit history providers).