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Ref: 17/31

Prof. Arnold Schilder
Chairman
International Auditing and Assurance Standards Board (IAASB)
International Federation of Accountants
529 Fifth Avenue, 6th Floor
New York, New York
10017 U.S.A.

Dear Professor Schilder,

RE: Proposed International Standard on Auditing 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

The International Association of Insurance Supervisors (IAIS) welcomes the opportunity to comment on the IAASB's Exposure Draft (ED) of the revised International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates and Related Disclosures*.

The IAIS acknowledges the significant work done by the IAASB in developing the ISA 540 (Revised) ED, and we are happy to have been able to participate and contribute to the work efforts of the IAASB's ISA 540 Task Force.

Overall, the IAIS believes the revisions will improve the requirements and guidance for the audit of accounting estimates, including estimates of insurance contract liabilities, and that it is an important step in the right direction with respect to the overall objective of enhancing audit quality in the public interest.

At the same time, the IAIS understands that the generic and principles-based nature of the ISA 540 ED requirements do not allow for a more detailed audit consideration of important aspects of the typically significant and complex estimates of insurance contract liability estimates that are made by insurance entities. Also, the IAIS believes there is a strong need for more detailed application material on the audit of financial institutions, including key accounting estimate considerations. Lastly, due to unfortunate timing, the particular audit considerations relating to IFRS 17 (Insurance Contracts) could obviously not be fully assessed during the development of the ISA 540 ED.

Consequently, the IAIS strongly encourages the IAASB to consider on a priority basis the further development of audit application or guidance material, such as an *International Auditing Practice Note* (IAPN), to better address the specific considerations around auditing insurance contract liabilities.

The appendix to this letter provides more detailed responses to the questions set out in the ED. This appendix was prepared on behalf of the IAIS by its Accounting and Auditing Working Group (AAWG). The AAWG's membership represents a subset of all IAIS members.

If you have further questions regarding this letter, please contact Mark Causevic at the IAIS Secretariat (tel: +41 61 280 8323; email: mark.causevic@bis.org) or Markus Grund, Chair of the IAIS Accounting and Auditing Working Group (tel: +49 228 4108 3671; email: markus.grund@bafin.de).

Yours sincerely,



Victoria Saporta
Chair, Executive Committee



Elise Liebers
Acting Chair, Financial Stability
and Technical Committee

Appendix: IAIS Responses to Questions set out in the Exposure Draft (ED) on the revised International Standard on Auditing (ISA) 540, *Auditing Accounting Estimates and Related Disclosures*

Overall Questions

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

On a general basis, the ED-540 looks to cover key matters in the development of accounting estimates, including new requirements for further audit procedures that respond to the reasons for a specific assessment of material misstatement, and relevant application material on topics such as complex modelling, model adjustments, use of point estimates, significant data and assumptions, inactive and illiquid markets, and internal controls.

However, the generic nature of the ISA requirements do not allow for a more detailed consideration of important aspects of significant accounting estimates made within particular industries, such as insurance industry. Many jurisdictions have (or have had) specific guidance around auditing insurance contract liabilities, and such guidance allows for the development of specific considerations to address the particular features of these typically significant and complex accounting estimates being made by insurance entities. With respect to ISA 540, given its development as a principles-based standard, more detailed guidance on particular insurance audit specificities would provide auditors with more clarity on ISA 540 application, as well as a stronger foundation for assessing auditors' compliance with its principles-based requirements.

Lastly, it is unfortunate that topical dialogue and experience on particular audit considerations around IFRS 17 (Insurance Contracts) could not have been more prominent during development of the revised ISA 540 given the late timing of the release of IFRS 17. The revised ISA 540 was developed without the benefit of IFRS 17 application experience and hindsight, which will come with time, and so there may be a need for some further considerations. Consequently, the IAIS strongly encourages the IAASB to consider on a priority basis the further development of audit application or guidance material, such as an *International Auditing Practice Note* (IAPN), to better address the specific considerations around auditing insurance contract liabilities.

2) Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?
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As we stated in our 4 May 2016 response to the IAASB's Invitation to Comment (ITC) *Enhancing Audit Quality in the Public Interest*, professional skepticism is by nature a questioning state of mind which can be better supported at many levels including through enhanced audit standards as well as better audit firm and engagement practices. At the standards setting level, we highlighted that IAASB literature needs to be sufficiently flexible and open-ended such that it not interpreted as an exhaustive or self-contained set of rules or procedures designed to 'prove' skepticism – i.e. to avoid a 'tick-box' auditor mind-set - and that can be meaningfully applied to new situations as they arise.

Also, professional skepticism is closely interrelated with professional judgment. Professional skepticism cannot be considered as professional without sound professional experience and judgment. In order for skepticism to function properly, the auditor must have the requisite

technical knowledge and experience that relates to key judgment areas in the audit of a particular industry.

By that criteria, the ED-540 appropriately reinforces the application of professional skepticism by focussing on audit objectives and allowing flexibility for external auditors to address the underlying drivers of the risk of material misstatement in a more tailored fashion. At the same time, the ED-540 speaks directly to indicators of management bias, includes a 'stand-back' assessment provision, and outlines that all relevant audit evidence obtained whether corroborative or contradictory needs to be considered – these are all useful considerations for reinforcing the application of professional skepticism.

In addition, the importance of specialized skills or knowledge to properly assess some accounting estimates is relatively well covered in paragraphs A67-A70. It would be useful in paragraph 27 of the ED to require auditors to document the basis for not requiring the use of an expert with specialized skills or knowledge when the inherent risk of material misstatements with an accounting estimate is not low, as we expect would often be the case for accounting estimates of insurance contract liabilities.

However, we also note the ISA 540 material could include more emphasis around auditors 'challenging' the consistency of the management assumptions, as this is a concrete application of professional skepticism. While not precluding further emphasis in other areas - as auditors should demonstrate professional skepticism in all stages of the audit - we suggest that further emphasis on 'challenging' management assumptions should particularly be included within the guidance material relating to auditor responses when the risks of material misstatement are not low due to the extent of judgement applied, and when assessing management bias. In particular, we suggest strengthening the auditor's role in assessing the consistency of management assumptions within an entity and in comparison to relevant objective information and market data.

Furthermore, more could be done outside of ED-540 to support the application of professional skepticism. This includes more at the standard-setting level, such as reinforcing the definition of professional skepticism within ISA 200 to make it less 'neutral' by introducing a concept of a questioning mind that would tend to exhibit a more doubting attitude.

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?

Yes, the flexibility of the standard allows it to be scalable. That said, our focus was on considerations when inherent risk is not low, as we expect this would be the usual situation for an audit of accounting estimates involving insurance contract liabilities.

4) When inherent risk is not low (see paragraphs 13, 15 and 17–20):
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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?

Generally, we think the requirements will support more effective identification and assessment of, and responses to, risks of material misstatement (including significant risks) relating to

accounting estimates. In particular, we find that para. 16 and A98-A100 on internal control considerations fit well within that section.

However, we feel the guidance material around third-party model considerations within para. A104 should be expanded, given the additional risks that management may not be fully aware of and/or have complete documentation relating to the model's limitations and features.

Also, we think there could be a stronger link established between the associated categories of an inherent risk that is not low and a significant risk, especially as the auditor is required to meet certain requirements under other ISAs when the risk is identified as a significant risk.

To establish a stronger link, the IAASB may want to consider:

- Including the following additional wording within para. 16 to make it consistent with requirements in ISA 330 para. 15, "...the auditor shall design and perform tests of controls in the current period to obtain sufficient appropriate audit evidence as to their operating effectiveness."
- Including the following additional wording at the end of the para. A76 "...including control activities relevant to that specific risk," as this would better reflect the ISA 315 specific requirements linked to the fact that a risk is considered a 'significant risk'.
- Expanding para. A76 to highlight the important ISA 315 para. 27 consideration that "In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk."

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?

Yes, we support requirements 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.

However, we find the ISA-540 could be better worded in certain areas discussing estimation uncertainty to ensure the focus is on the extent of it and not merely its existence. Clearly, the para. 9 (a) definition of 'accounting estimate' highlights it is a measurement subject to estimation uncertainty, i.e. all accounting estimates will have estimation uncertainty. Consequently, when identifying, assessing and responding to the risk of material misstatement due to estimation uncertainty, the relevant consideration should appropriately be on the extent of the estimation uncertainty, not merely its existence. However, while para. 13 (c) discusses extent of estimation uncertainty, the para. 19 wording does not, and can be read as focussing more on its existence. We suggest adding wording to para. 19 to ensure the focus is properly on the extent of estimation uncertainty as the relevant consideration.

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?

Generally, we believe there is sufficient guidance in relation to the proposed objectives-based requirements in para. 17 to 19.

However, we are concerned with the potential for confusion around the use of particular nuanced key words in multiple contexts within the ED, for example:

- As noted within para. A2, the notion of ‘reasonable’ that is used in various paragraphs is meant to indicate that all the relevant requirements of the applicable financial reporting framework have been applied appropriately. This definition of ‘reasonable’ is clearly meant to be different from the meaning of ‘reasonable assurance’ (para 37 in ISA 700), and is (as outlined in A3) not identical to the meaning of ‘appropriate’. However, we are concerned that the nuances being applied to these commonly used words can create confusion. The IAASB should ensure that the definitions introduced are consistently applied; we note that the use of the term ‘reasonable’ in para. A124 does not appear to be consistent with its definition in para. A2;
- The para. 9 (f) definition of ‘outcome of an accounting estimate’ clearly highlights it is an actual monetary amount that results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by an accounting estimate. However, we note the term ‘outcome(s)’ is used in the ED in different contexts, many which are relevant for the audit of insurance contract liabilities (“range of outcomes”, “outcomes scenarios” etc.), and so this may create some confusion. Also the term ‘outcomes of the accounting estimates’ is used in para. A109 within a context that is not consistent with the para. 9(f) definition.

We suggest this wording be revisited to increase clarity.

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?

Yes, we generally believe the approach prescribed within para. 20 and the related application material in para. A128–A134 will be more effective for evaluating whether management’s point estimate is reasonable or misstated. However, we encourage the IAASB to develop future examples and other support tools to address special audit considerations relating to the application of ISA 540 para. 19 b) and para. 20, in particular for audits of financial institutions.

We like the stronger requirement for auditors to address uncertainty (where management have not) by developing a range included at paragraph 19(b). We suggest further application material on ranges be brought into the requirements part of ISA, making it clearer that the auditor should be satisfied that the point estimate selected by management is in an appropriate place within a range. For example, the wording in A123, that management’s estimate “is appropriately representative of the range of reasonably possible outcomes” is important, but appearing at the 6th bullet point, is rather buried. The lead in wording to A123 should be stronger, for example as the second sentence already includes “as applicable” at the end, the earlier “may be relevant” should become “are” or “will be” relevant. The application material at A116-A118 is useful and should be retained.

We also believe it would be useful to highlight within para. A131 that when the auditor uses management’s model to develop a point estimate or range, the auditor first needs to obtain

sufficient and appropriate evidence that the internal controls associated with the model are operating effectively.

- 6) 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?**

Yes, we believe the requirement in paragraph 23 and related application material in para. A2–A3 and A142–A146 will result in more consistent determination of a misstatement, including when the auditor uses an auditor’s range to evaluate management’s point estimate

Conforming and Consequential Amendments

- 7) With respect to the proposed conforming and consequential amendments to ISA 500 regarding external information sources, will the revision to the requirement in paragraph 7 and the related new additional application material result in more appropriate and consistent evaluations of the relevance and reliability of information from external information sources?**

We think the proposed new ISA 500 material regarding external information sources should include the additional requirement that the reliability and credibility of the external information source be assessed, and in particular when the information source is not widely used. With that, the new material should be helpful in promoting better evaluations of audit evidence that is based upon data from external information sources. This area seems to be growing in importance as entities are increasingly engaging in complex investment, hedging, financing, and other activities that are using data from external information sources to support the determination or validation of their estimates.

Request for General Comments

- 8) 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.**

We have no comments to provide on this question.

- 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 IAIS welcomes the introduction of the revised ISA 540 as soon as possible, noting that it provides a more relevant basis for the audit of accounting estimates made under IFRS 9

(Financial Instruments) which has a mandatory effective date for annual periods beginning on or after 1 January 2018, with earlier application permitted.

However, we also appreciate the need to allow some time for jurisdictions and firms to transition to the substantively revised ISA 540. Consequently, we support the IAASB's view 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, with earlier application to be permitted and encouraged. On that latter point, even before the approval of the final ISA, we believe that audit firms could and should be taking preliminary steps (such as internal education sessions, enhancements to their audit approach etc.) to ensure they can early apply the improved standard to their audits of accounting estimates.

Additional Comments

The IAIS also provides the following additional comments on the ED-540:

- We fully support the changed objective which recognises the audit of accounting estimates disclosed within financial statements as being at the same level as those recognised within the financial statements. The auditor's sustained focus on the quality of disclosures is an important part of the auditor's overall work on accounting estimates;
- At the end of para. 4, there is an unsupported reference to auditors being limited in their ability to reduce estimation uncertainty below a certain level. Although the sentence begins by saying "The ISA also recognises", there appears to be no other related reference elsewhere in the ED regarding the ability to reduce estimation uncertainty, and it is debatable as to whether auditors can reduce estimation uncertainty (which involves an inherent lack of precision) at all, and so we recommend removing the last part of the last sentence within para. 4;
- The objective outlined in para. 8 can be better articulated to ensure it encompasses the 'completeness' assertion; auditors need to obtain evidence that all accounting estimates that have to be recognized or disclosed are effectively recognized or disclosed. A simple fix may be to have para. 8(a) say "...whether or not...";
- We suggest that para. 10(f) and/or A48 include a reference to the specific requirements of para. 13 of ISA 315 which says:
"When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel."
- Paragraph 11 requires the review of accounting estimates included in the previous period financial statements, but the supporting Application Material (i.e. A61 opening sentence) refers to 'previous periods'. Given that evidence will be relevant from before the previous period only, we suggest that the requirement indicates that previous periods should be assessed;
- Regarding para. 25 and A153-154 on written representations, the auditor should also obtain written representations from management acknowledging management's responsibility for establishing and maintaining effective internal controls in relation to certain accounting estimates and disclosure. Specifically, we suggest adding within para 153 a reference to para. A11 of ISA 580, which says:

“In addition to the written representation required by paragraph 11, the auditor may consider it necessary to request management to provide a written representation that it has communicated to the auditor all deficiencies in internal control of which management is aware.”

- We welcome the new reference to ISA 265 and reporting on deficiencies in internal controls at paragraph 26;
- We note the documentation requirement at paragraph 27(b) has been developed to include the auditor’s evaluation of possible management bias on whether the financial statements are materially misstated and we support this change;
- The application material to the documentation requirements has been expanded and we support the new material at A158;
- Appendices 1 and 2 include useful material relevant to the application of the ISA and should be retained as part of the ISA. Appendix 2 is particularly valuable as it explains the factors of uncertainty, judgement and estimation uncertainty which are key to the ISA.