

Supplement B to Agenda Item 2

Preliminary Analysis of Responses to Question 2 of the Exposure Draft

Section I: Question included in Exposure Draft

1. The following question was asked in the exposure draft:
 2. *Do the requirements and application material of ED-540 appropriately reinforce the application of professional skepticism when auditing accounting estimates?*

Section II: Staff Analysis of Respondents' Views¹

General Observations

2. A majority of respondents² generally believed that the approach taken in Exposure Draft of Proposed ISA 540 (ED-540)³ appropriately reinforces the application of professional skepticism when auditing accounting estimates. In particular, respondents most noted the following key provisions of ED-540 as improvements:
 - Emphasizing the importance of professional skepticism in the introduction (paragraph 5)
 - Enhanced risk assessment requirements (paragraph 10)
 - More granular, objectives-based work effort requirements to help auditors tailor the response to address the underlying drivers of the assessed risk of material misstatement (paragraphs 17-20)
 - The stand-back provision, including the consideration of all audit evidence obtained, whether corroborative or contradictory (paragraph 23)
 - Additional focus on the consideration of management bias (paragraph 24)
3. Notwithstanding the level of support for these provisions in ED-540, respondents also expressed certain concerns and offered additional suggestions for further strengthening the requirements and guidance regarding the application of professional skepticism. These are discussed further in the sections below.

¹ In this paper the following terms have been used:

- "A respondent" = 1;
- "A few" = 2–3;
- "Some" = 4–6;
- "Several" = 7–11;
- "Many" = 12–34;
- "Majority" = more than 50%; and
- "Significant majority" = greater than ~80%.

² *Regulator:* BCBS, ESMA, IAIS, IRBA, UKFRC, *Investors & Analysts:* CFA, NSS; AUASB, CAASB, CNCC-CSOEC, HKICPA, IDW, MAASB, NZAuASB, *Accounting Firms:* BDO, DTT, EYG, GTI, KPMG, PKF, PWC, RSM, *Public Sector:* ACAG, AGA, AGC, AGNZ, CIPFA, GAO, INTOSAI, PAS, *Member Bodies:* ACCA-CAANZ, AE, AICPA, ANAN, CAI, CPAA, EFAA, FACPCE, IAA, IBRACON, ICAG, ICAP, ICAS, ICAZ, ICPAK, KICPA, NASBA, SAICA, SMPC, *Individuals & Others:* NDEG

³ Proposed ISA 540 (Revised), *Auditing Accounting Estimates and Related Disclosures*

4. Several respondents⁴ expressed support for the IAASB's approach of reinforcing the application of professional skepticism through the nature of the requirements and related application material rather than including sprinkling statements or reminders about the concept throughout the standard. Others noted the importance of continuing to liaise with regulators on this topic.⁵
5. A number of respondents acknowledged the Professional Skepticism Working Group established by the IAASB, and urged the IAASB to continue the work of that group on a priority basis.⁶ Other respondents⁷ noted that the IAASB should continue to look for other ways to address professional skepticism in the revision of ISA 540,⁸ such as with additional guidance or examples. Two respondents noted that more could be done outside of ISA 540 to reinforce professional skepticism.⁹
6. Two respondents¹⁰ suggested that the final standard be clear that the auditor cannot reduce inherent estimation uncertainty by performing more audit procedures and applying professional skepticism.
7. A few respondents¹¹ noted that the prescriptiveness and rules-based nature of the standard, along with length of the application material, may result in a checklist mentality being applied, which may diminish the auditor's professional judgment and professional skepticism and lead to an unintended decline in audit quality.

Links to Management Bias and Management Judgment

8. Respondents commented in various ways about the link between the application of professional skepticism and the consideration of possible management bias and the need for management judgment in making accounting estimates.
9. Two members of the Monitoring Group¹² commented on the interrelationship of professional skepticism with management judgment. One¹³ recommended that the IAASB includes examples of how auditors can demonstrate the application of professional skepticism for accounting estimates that are subject to a high degree of management judgment, and therefore may be more susceptible to the potential for management bias (paragraph A85). This respondent also recommended that paragraph 5 be strengthened to note the importance of demonstrating professional skepticism throughout the audit.
10. Several respondents noted that an important aspect of applying professional skepticism relates to evaluating management's judgments, including the selection of assumptions and methods. In this regard, one respondent¹⁴ noted the absence of clear requirements for the auditor to challenge whether management's judgments were the most appropriate in the circumstances, and

⁴ Regulators: UKFRC, Firms: DTT, PWC, NSSs: AUASB, Member Bodies: CPAA, ICAEW, ICAS, Individuals & Others: NDEG

⁵ Member Bodies: AE, ICAEW, ICAS, SMPC

⁶ Regulators: BCBS, ESMA, AE, Member Bodies: IBRACON, Investors & Analyst: CFA

⁷ Regulators: BCBS, EBA, ESMA, IOSCO, IRBA, NSSs: NBA, Member Bodies: ICAP

⁸ ISA 540, Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

⁹ Regulators: IAIS, Member Bodies: IBR-IRE

¹⁰ NSSs: NBA, Regulator: AE

¹¹ NSSs: AUASB, NZAuASB, Public Sector: AGNZ

¹² Regulators: BCBS, IAIS

¹³ Regulators: BCBS

¹⁴ Regulators: UKFRC

suggested there is room for use of words such as “question” and “challenge” in this context. Few other respondents agreed.¹⁵

11. Some respondents¹⁶ indicated that the guidance relating to management bias could be clarified. Two respondents¹⁷ suggested that the auditor’s focus should be on identifying and assessing indicators of *inappropriate* management bias, i.e., bias which could result in material misstatement, noting that indicators of possible management bias themselves do not constitute misstatements for the purpose of drawing conclusions on the reasonableness of individual accounting estimates.

Stand-Back Requirement

12. Respondents suggested various enhancements to, and the need for clarification of, the stand-back provision. These comments and suggestions include:
 - The requirement needs to be more explicit in its wording and call out exactly what the intent of the requirement is.¹⁸
 - The stand-back evaluation should be amended to focus on whether the auditor has exercised a sufficient level of professional skepticism.¹⁹
 - It is not clear whether the stand-back provision applies when the auditor has assessed the inherent risk of the estimate as “low”, or only when the inherent risk is assessed as “not low”.²⁰
 - Provide application guidance addressing examples or best practices in performing the stand-back review in order to demonstrate the application of professional skepticism.²¹
13. One respondent²² questioned how the stand-back requirement is different from what is done currently on audits and therefore whether the addition of this requirement would be effective in driving the application of professional skepticism. This respondent also noted that subjectivity and bias are inherent features in some accounting estimates, for example, expected credit losses, and as such, there will be no practical way to reduce management bias in these estimates.

Documentation

14. Several respondents, including one Monitoring Group member,²³ called for various enhancements to the documentation requirement and related application and other explanatory material to demonstrate the application of professional skepticism.

¹⁵ Regulators: **BCBS**, EBA, NSSs: AUASB

¹⁶ Firms: GTI, KPMG, Member Bodies: ACCA-CAANZ, Regulators: **BCBS**, Member Bodies: MAASB

¹⁷ Firms: GTI, KPMG

¹⁸ NSSs: AUASB, Firms: BDO

¹⁹ Regulators: **BCBS**, EBA, **IOSCO**

²⁰ Firms: GTI, Member Bodies: NZAuASB

²¹ Firms: BDO, Preparers of Financial Statements: ABA, Member Bodies: ICAEW

²² Preparers of Financial Statements: ABA

²³ Regulators: **BCBS**, EBA, Firms: BDO, Member Bodies: ACCA-CAANZ, IBRACON, ISCA, SMPC, NSSs: AUASB

Other Suggestions for Changes to Requirements or Application Material

15. Additional suggestions relating to various aspects of ED-540 were provided by respondents, often noting that guidance in these areas would contribute toward the goal of enhancing professional skepticism. These suggestions included the following:
- Clearer requirements and application guidance in the final standard that the requirement to produce evidence supporting the reasonableness of accounting estimates lies with the preparer, not the auditor.²⁴
 - Require the auditor to consider whether management has used the *most* appropriate, rather than *an* appropriate, approach in making an accounting estimate in view of the circumstances.²⁵ This would support the auditor's responsibilities to communicate with those charged with governance in accordance with ISA 260 (Revised).²⁶
 - Additional guidance on the auditor's evaluation of qualitative disclosures.²⁷
 - Additional guidance on dealing with contradictory evidence. For example, considering revisions to the requirements before the stand-back to drive actions that are more likely to ensure the auditor identifies potential alternative sources of evidence that may be contradictory,²⁸ or providing more guidance about how the auditor may deal with contradictory evidence when it is discovered in performing procedures, and prior to performing the overall evaluation of accounting estimates.²⁹
 - Make the application material in paragraph A101 applicable in all circumstances, not just for the risk factor of complexity.³⁰ Others noted that this application material takes the exercise of professional skepticism too far.³¹

²⁴ NSSs: AUASB

²⁵ Regulators: UKFRC

²⁶ ISA 260 (Revised), *Communication with Those Charged with Governance*

²⁷ Firms: EYG, Member Bodies: ICAS, SAICA

²⁸ Regulators: UKFRC

²⁹ Firms: EYG, Member Bodies: SAICA

³⁰ Regulators: CEAOB, IFIAR

³¹ NSSs: AUASB, Firms: GTI