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Arnold Schilder
Chairman
International Auditing and Assurance Standards Board
529 Fifth Avenue 6th Floor
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Subject: Proposed International Standard on Auditing 540 (Revised) Auditing Accounting Estimates and Related Disclosures

Dear Mr Schilder

The European Banking Authority (EBA) welcomes the opportunity to comment on the International Auditing and Assurance Standards Board (IAASB) Proposed International Standard on Auditing (ISA) 540 (Revised), Auditing Accounting Estimates and Related Disclosures (the ED hereafter).

The EBA has a strong interest in promoting sound and high quality auditing standards for the banking and financial industry as well as high quality financial reporting by financial institutions, which are key elements of market confidence and discipline.

The EBA welcomes the IAASB efforts at enhancing the requirements for the audit of accounting estimates. Accounting estimates affect most of the components of the financial statements of financial institutions and their importance will increase further in the context of the implementation of the expected credit losses (ECL) requirements of IFRS 9, *Financial Instruments* (IFRS 9), where accounting estimates are likely to become more complex, require the use of more judgement and be more uncertain compared to the current accounting estimates under incurred loss frameworks.

The EBA urges the IAASB to finalise the ED as soon as possible and in a way that delivers a high quality auditing standard. Understanding that the final standard will not be available at the time of initial application of IFRS 9, we encourage the IAASB to promote early adoption of the standard where it believes it to be practicable for auditors. Timely publication of the revised ISA 540 will help to enable early adoption.

The EBA supports the principles-based approach of the ED, which focuses on the requirements of the audit approach in order to address the risks of material misstatements arising from accounting estimates. This principles-based approach should ensure that the auditor's responses to the risk of material misstatement are effective, avoiding any so called 'bright lines' when audit procedures are prescribed for each reason underlying the assessed risk of material misstatement. However, we believe that the enforceability of the standard could be further improved, among others by improving the application guidance and thus helping auditors to meet the objectives of the ED and by including some of the application guidance of the ED as requirement at standard's-level.

In addition, although we recognise that a Professional Skepticism Working Group[1] has been established by the IAASB, we believe that professional skepticism should also be addressed in the revised ISA 540 as we consider that professional scepticism should underpin the performance of an audit at all times and it is key in ensuring high quality audit of ECL. We also believe that the ED could include stronger requirements on auditors to challenge management and to obtain specific audit documentation to demonstrate how they have exercised professional scepticism in their audit of accounting estimates.

The EBA welcomes also the increase in the references in the ED to the audit of internal controls. An appropriate internal control framework will be key to ensuring the reliability and correctness of accounting estimates in general. Having said that, the ED could benefit from placing more emphasis on the importance of the audit of internal controls and making it clear that in the context of the audit of ECL, in most cases, these controls will need to be tested and that substantive procedures alone will not be sufficient.

In this regard, as part of the audit of internal controls and other audit procedures to be performed, we support the requirement in the ED for the auditors to develop their own point estimate or range for other than low risk estimates to evaluate the reasonableness of management's point estimate, and the related disclosures in the financial statements, when possible and appropriate. However, we understand that in the context of the audit of ECL which may include complex models and several assumptions, auditors may not always be able to develop an independent point estimate or range. Therefore, the ED could include more guidance on the circumstances (and criteria) under which the auditors should develop their own point estimate or range and an additional step of requiring auditors to first request management to consider alternative assumptions or to provide additional disclosures related to the estimation uncertainty before requesting auditors to develop their own estimates.

[1] https://www.iaasb.org/projects/professional-skepticism

Finally, we also suggest that some of the elements of the ED could be strengthened and further clarified. In particular, with regards to the auditor's response to the risk of material misstatement, it is important that more guidance is provided on how the outcome of the use of an auditor's own range or point estimate interacts with the level of the materiality applied in the audit and how this may be reflected in the audit report.

Our comments on the ED are set out in the Annex. We have not explicitly addressed the specific questions raised in the ED.

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely

[SIGNED]

Andrea Enria

Appendix

General comments

The EBA welcomes the IAASB efforts at enhancing the audit requirements for the audit of accounting estimates, particularly in the context of the implementation of the requirements of the ECL accounting frameworks.

The EBA had previously asked the IAASB to ensure that their auditing standards can address the challenges related to the audit of IFRS 9 ECL estimates (EBA response to the '*Invitation to Comment: Enhancing Audit Quality in the Public Interest: A focus on Professional Scepticism, Quality Control and Group Audits*' in May 2016[2]). We acknowledge that the IAASB has chosen to update ISA 540 to deal with all types of accounting estimates, and thus should be better placed to address future changes in accounting standards. However, the IAASB's approach means that the ED contains limited requirements and application guidance specific to the audit of ECL. In this regard, we recommend that the IAASB first moves certain sections of the application guidance into the main body of the standard in order to emphasise its importance (see elsewhere in this letter) considering also that the application guidance is disproportionately large currently compared to the main text of the ED and that more requirements in the main text of the standard will help the enforceability of the ISA.

Timeline

As EU banking regulators, our primary concern regarding estimates is around the audit of banks' IFRS 9 ECL measurement and disclosures. While other estimates are important, not least fair value estimates, the introduction of IFRS 9 brings significant new challenges to both preparers and auditors. For this key post-crisis reform to be successful there must be regulator and market confidence in ECL and high quality audits of ECL are an important element that could contribute to that confidence.

For these reasons we urge the IAASB to complete the revised ISA 540 as soon as possible without compromising the quality of the standard. Ideally we would like the revised ISA 540 to be applicable for 2018 audits but we recognise that this would not be in line with the usual IAASB adoption timelines. Nevertheless, we encourage the IAASB to promote early adoption of the

2 https://www.eba.europa.eu/documents/10180/1363703/%28EBA+2016+D+695%29%20Letter+to+Mr+Schilder+IAASB+re+Overview+ITC+Audit+Quality.pdf

standard where it believes it to be practicable for auditors. In addition, timely delivery of the revised ISA 540 will help to facilitate early adoption.

Nature of accounting estimates

We agree with the identification of the three factors of accounting estimates (complexity, judgment and uncertainty) in paragraph 13 of the ED as the auditor shall consider these elements when identifying and assessing the risks of material misstatement. These three elements are especially relevant to the audit of ECL which is likely to involve a high degree of judgment and complexity, and not just the 'uncertainty' currently envisaged by ISA 540.

We also suggest splitting paragraph 3(c)(ii) of the ED into two bullet points: (ii) s*elect an appropriate management point estimate* and (iii) *make appropriate related disclosures in the financial statements*. Appropriate disclosures with respect to estimation uncertainty are necessary in any case, and it is not clear why this is mentioned together with selecting an appropriate management point estimate.

Key concepts of this ISA - Professional scepticism

Although we recognise that a Professional Skepticism Working Group has been established[3] by the IAASB, we believe that professional skepticism should also be addressed in the revised ISA 540 as we consider that professional scepticism should underpin the performance of an audit at all times and it is key in ensuring high quality audit of ECL. In this regard, we welcome the explicit reference in the ED to the importance of professional scepticism in paragraph 5, being a key concept of the standard and linked to management bias. Indeed, the consideration of management bias throughout the audit of accounting estimates is of outstanding importance for us. In areas which require the exercise of judgement, there is a potential for bias with respect to methods, assumptions and data. This is of particular importance for the estimation of ECL, because of the high level of complexity, estimation uncertainty and judgement embedded in ECL.

In addition, we support the development of the concept of professional scepticism in the context of estimation uncertainty in paragraph A93 of the application guidance. However we think the connection between estimation uncertainty and professional scepticism could be included in the standard itself (e.g. in paragraph 5 where professional scepticism is mentioned under the 'Key Concepts of this ISA').

We believe that the development of the concept of professional scepticism at the beginning of the application guidance is missing, as paragraphs A2-A3 ('Key Concepts') address only the key concept of paragraph 6 related to the need for an overall evaluation based on the audit

[3] https://www.iaasb.org/projects/professional-skepticism

procedures performed ('stand-back' provision). To us, the introduction of the stand-back provision in paragraphs 6 and 22-23, which we welcome, should be an area where professional scepticism needs to be applied. We recommend therefore that the stand-back evaluation also includes the auditor's overall consideration of whether a sufficient level of professional scepticism was applied.

In addition, the ED could be more explicit and require auditors to use professional scepticism by challenging management when appropriate, for example in relation to their judgments and assumptions (e.g. by encouraging or requiring the auditor to look for contradictory evidence). We recommend that stronger wording is used when it comes to 'challenging' management (e.g. paragraph A67, where specialised skills or knowledge are addressed, could also read that these need to be coupled with a questioning mindset and sound professional judgment by the auditors) and that special documentation in the context of 'challenging' management is required (e.g. paragraph 27 could include a requirement for auditors to document how, why and when they applied professional scepticism and if they have a sufficient level of seniority related to key judgment areas in the audit of a particular industry such as banking or insurance).

In this regard, we believe that the quality of accounting estimates will be enhanced if the revised standard includes minimum documentation requirements for the audit of significant accounting estimates in addition to the proposed requirements in paragraph 27 of the ED. These documentation requirements should demonstrate the application of professional scepticism by guiding the auditor to focus on certain areas and issues for which supporting documentation should exist, including significant judgements made by the auditor when assessing estimates

Use of specialised skills or knowledge

Paragraph 12 and the related application guidance requires the auditor to determine early in the audit process whether specialised skills or knowledge are necessary to perform the audit engagement. In addition, paragraph 14 of the ED requires the auditor to determine whether specialised skills or knowledge are required in order to respond to the risks of material misstatement related to accounting estimates. We are supportive of these requirements and we also welcome the explicit clarification in paragraph A69 that for the audit of ECL of internationally active banks the auditor is likely to conclude that the use of experts will be necessary. In addition, we suggest that paragraph A69 refers to all banks instead of internationally active banks only as the audit of ECL is likely to be relevant to all banks and hence the auditor is likely to conclude that the use of experts will be necessary.

Risk assessment - understanding of regulatory factors

For regulated entities like banks, more specific regulatory expectations may exist to guide the implementation of financial reporting requirements related to accounting estimates (e.g. EBA's 'Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses 'EBA GL on ECL' issued in May 2017[4]). In such cases, the auditor should take due consideration of the relevant regulatory expectations and should obtain an understanding of how these expectations have been met. We therefore very much support the inclusion of paragraphs 10(b) and A14-A15 referring to regulatory factors as part of the risk assessment, particularly in the context of the audit of banks.

On the other hand, in terms of the application of principles-based accounting frameworks where judgement is required, paragraph A15 highlights that regulatory requirements may 'not be consistent' with the requirements of the applicable financial reporting framework, which may indicate 'potential risks of material misstatement'. However, we believe that the example provided in this paragraph does not present the issue in a clear and holistic way and we suggest replacing this example by referring to the valuation rules for accounting and prudential purposes and bringing to the auditor's attention that differences between the objectives in the valuation of financial instruments for prudential and accounting purposes may exist and which can lead to different requirements and inputs used for each of them. In addition, we suggest changing the text of paragraph A15 by replacing 'not consistent' with 'not fully aligned', and 'potential risks of material misstatement' with 'bias' as the objectives of regulatory and accounting requirements have both similarities and differences.

Risk assessment[5] - understanding of how management makes accounting estimates

Methods used to develop accounting estimates

As also indicated in the EBA GL on ECL[6], the use of (temporary) adjustments to model results, often referred to as 'overlays', requires the application of significant judgement and creates the potential for bias. Therefore, it is important that the auditor pays particular attention to such adjustments applied by management and challenges their appropriateness with regard to the financial reporting requirements. In this sense, we agree with the application guidance provided in A26-A31 and with the explicit reference in A30 for the auditor to consider whether adjustments are made to the output of models used. But to give the related audit requirements in the

[4] EBA/GL/2017/06 https://www.eba.europa.eu/regulation-and-policy/accounting-and-auditing/guidelines-on-accounting-for-expected-credit

[5] The following comments deal primarily with the requirements for Risk Assessment Procedures and Related Activities, although testing of internal controls can be considered as falling under the responses of the auditor to the assessed risks of material misstatement.

[6] EBA/GL/2017/06, paragraphs 54-56.

application guidance more prominence, we suggest that besides paragraph 18(c) on the auditor’s responses to the assessed risks of material misstatement, overlays are also mentioned in the main text of the standard in the risk assessment procedures of the auditor in paragraph 10 (e)(i).

In addition, the ED already recognises in A54 that those charged with governance have a strong role to play where accounting estimates require significant judgement, have high estimation uncertainty or are complex to make. We believe that the list of factors under A54 should be extended to include as an additional factor the use of overlays by management, together with a link to A30.

Significant data

We note that the definition of ‘significant data’ is included in A35. We therefore suggest a reference to paragraph A35 is included in paragraph 10 (e)(iii).

Internal controls

We welcome that the ED requires the auditor to obtain an understanding of the design and implementation of internal controls as they relate to making accounting estimates. An appropriate internal control framework will be key in ensuring the reliability and correctness of accounting estimates in general, by virtue of their inherent characteristics.

The more judgement, estimation uncertainty and complexity is involved in the determination of accounting estimates, the greater the need will be for robust governance procedures and a strong control framework. ECL accounting estimates for the financial statements of a bank are in our view a key example of an area where effectively operating internal controls will be of particular importance. Therefore, we expect that in the case of ECL, the effectiveness of controls is more likely to be subject to audit. Having said that, we suggest to explicitly mention this in paragraph 16 and that for the audit of ECL, the relevant controls are likely to be tested while substantive procedures alone will not be sufficient. Alternatively, paragraph A98 could be moved from the application guidance to the main text of the standard to supplement paragraph 16.

Identifying and assessing risks of material misstatement

Although, as mentioned above, we support the proposals for auditors to consider the factors listed in paragraph 13 when identifying and assessing the risk of material misstatement, we would like to stress that we consider that ECL accounting estimates should be systematically considered to have inherent risk which is not low. We therefore believe that paragraph A73 should not limit accounting estimates influenced by inherent risk that is not low to banks active in different markets but rather extend it to all banks. The fact that a bank is active in different markets is not considered relevant as such to the assessment of the risk of material misstatement related to accounting estimates.

ECL accounting estimates will always be 'sensitive to the selection of different methods or to variations in the assumptions and data used' (as referred to in paragraph 13(c) and A92) and we consider that numerous factors could create sensitivity. In such context, we believe that it would be valuable that some additional guidance was provided on how an auditor needs to consider and assess an accounting estimate's sensitivity and how an auditor needs to document its consideration of the accounting estimate sensitivity.

Finally, we are pleased to note that auditors should, in line with paragraph A78, consider additional relevant factors, such as regulatory requirements, when assessing the risk of material misstatements. We would however recommend having such paragraph A78 placed as a requirement in paragraph 13 of the standard rather than in its application guidance as we consider that regulatory requirements (such as specific prudential own funds requirements for banks) will significantly impact and increase the risk of material misstatements related to accounting estimates.

Response to the assessed risks of material misstatements - point estimate or range

The EBA welcomes the objectives-based approach in the ED for the auditor to design and perform audit procedures to respond to the identified risks of material misstatements. This approach should ensure that the auditor's response to the risk of material misstatement is effective avoiding any so called 'bright lines' when audit procedures are prescribed for each reason underlying the assessed risk of material misstatement. We also believe that in order for the revised standard to be effectively implemented, this approach should be enhanced by adding in the application guidance of the ED some examples of audit procedures to be performed in order to meet the objectives.

We also support the requirement in paragraph 19(b) of the ED for the auditor to develop their own point estimate or range for other than low risk estimates to evaluate the reasonableness of management's point estimate and the related disclosures in the financial statements in case management has not appropriately understood or addressed estimation uncertainty. Indeed, as part of the audit of internal controls and other audit procedures to be performed, we support this requirement in the ED when it is possible and appropriate. Such requirement, when possible and appropriate to be applied should increase the effectiveness of the audit procedures as it encourages the auditors to challenge management's assumptions and thus fosters the application of professional scepticism.

However, we understand that in the context of the audit of ECL, which may include complex models and several assumptions, auditors may not always be able to develop an independent point estimate or range. Therefore, the ED could include more guidance on the circumstances (and criteria) under which the auditors should develop their own point estimate or range besides the case mentioned in paragraph 19(b). In addition, the ED could include an additional step (as referred to in paragraph A126) of requiring auditors to first request management to consider alternative assumptions or to provide additional disclosures related to the estimation uncertainty before auditors develop their own point estimates or ranges in order to assess the reasonableness of management’s point estimate. In the cases when an auditor’s own point estimate or range cannot be developed, the application guidance could clarify that the auditor should focus among others on testing the relevant internal controls and the reasonableness of management’s point estimate and that substantive procedures alone will not be sufficient.

In addition, we support connecting the results of this audit procedure with the level of the materiality applied in the audit (paragraphs A144 and A145) and in particular, that the standard includes more guidance on how the outcome of the use of an auditor’s own range or point estimate interacts with the level of the materiality applied in the audit and how this may be reflected in the audit report.

Paragraph 20 includes requirements for the development of auditors’ range, when the auditor concludes that this is appropriate. However, it is not clear why the paragraph mentions only auditors’ ranges and not also point estimates, as these provisions seem to be relevant for the latter as well. We would welcome the inclusion of more guidance in the ED in paragraphs A128-A130 on the circumstances in which the development of an auditor’s point estimate may be more appropriate than the development of a range and whether different objectives may be met by each of these.

Paragraph 20(b) of the ED requires the auditor to include reasonable amounts in the range of estimates. However, in the case of ECL, due to the nature of these estimates which include several assumptions and therefore can vary considerably, we expect that there will be significant estimation uncertainty. Therefore, we believe that the inclusion of reasonable amounts only in the range would not be sufficient to assist the auditor in developing an estimation range to effectively support the audit procedures. As such, we would welcome that such audit procedure is linked to the considerations of the indicators of management bias in paragraphs A148-150 and the auditor’s disclosures in paragraphs (such as those in paragraphs A125 and A138).

Paragraph A123 includes guidance on those matters relevant in obtaining sufficient appropriate audit evidence about the reasonableness of management’s point estimate and related disclosures. However, we believe that the current wording of the paragraph could be strengthened (for example replacing ‘may’ with ‘are’ and moving it to the main text of the standard), as indeed, when applicable, these matters will always be relevant to the audit procedures performed.

Other comments

The EBA notes that the audit of accounting estimates has been a recurring finding in audit inspections, particularly for financial institutions. In this regard, the EBA supports the continued engagement by the IAASB with the International Forum of Independent Audit Regulators (IFIAR) and Committee of European Auditing Oversight Bodies (CEAOB) to enhance the enforceability and effectiveness of the revised ISA 540.

The EBA supports the proportionate approach in the ED regarding the application of the requirements which aims to meet the objectives of the ISA 540 without undue cost and effort through the introduction of additional application material with considerations specific to smaller entities. These proposals are mainly in the form of reducing the requirements in the case of the audit of smaller entities. However, considering that the audit of smaller entities includes different challenges to the audit of larger ones, we would welcome specific guidance in the ED in this respect.

In addition, the EBA agrees that both the accounting estimates and the disclosures around them are important and supports auditors obtaining audit evidence to assess whether disclosures are reasonable in the context of the applicable financial reporting framework (paragraph 19 of the ED). We also suggest that the ED emphasises further the importance of complete and focused disclosures, which should be subject to appropriate audit procedures, by moving some of the application guidance in A120-A122 into the main requirements of the standard.

We welcome the guidance in the ED on the audit of financial instruments in inactive or illiquid markets in paragraphs A36-38, which has been frequently requested in the past as it is an area of concern from a prudential perspective. We would suggest that the ED is further amended to refer to the audit work related to the disclosures for those financial instruments in inactive or illiquid markets, as it is expected that the relevant accounting estimates for these financial instruments will be accompanied by certain disclosures and auditors would need to perform additional audit procedures in this respect.

Finally, we welcome the reference in paragraph A157 of the ED regarding the usefulness of the communication between supervisors, regulators and auditors during the audit, which is also consistent with the EBA Guidelines on the communication between competent authorities and auditors[7]. We would suggest also that this paragraph is strengthened by encouraging auditors to initiate communication directly with the supervisors and regulators and where permitted to share information about the audited bank which is relevant to their respective functions.

[7] EBA/GL/2016/05 https://www.eba.europa.eu/regulation-and-policy/accounting-and-auditing/guidelines-on-communication-between-competent-authorities-and-auditors