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Committee of European Banking Supervisors

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Dear Mr Sylph

Proposed Redrafted International Standard on Auditing ISA 540 (Revised and Redrafted), Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures

The Committee of European Banking Supervisors welcomes the opportunity to comment on the ISA 540 (Revised and Redrafted), Auditing Accounting Estimates Including Fair Value Accounting Estimates, and Related Disclosures (ED)

Through their opinions on annual accounts and annual reports, external auditors constitute an integral part of the public oversight model and contribute to the financial stability of the market. As banking supervisors we therefore have an interest in ensuring that auditing standards, which are the basis for audit work, are of a high quality and are clear and capable of consistent application.

While the Committee wishes to express its broad support for presenting a revised and redrafted combined standard, we do have some concerns about whether this standard provides sufficiently comprehensive and robust guidance on the auditing of fair value estimates and disclosures. We appreciate that the ED 'introduces guidance on certain relevant fair value auditing considerations that are not addressed at present in extant ISA 545' (ED explanatory memorandum, p6). However, given the increased use of fair values in financial reporting, we still do not believe there is adequate guidance in this area. In particular we are concerned whether there is sufficient guidance on:

- the audit procedures where there are not observable market data and models have been used to generate an accounting estimate;
- the differential audit work involved in assessing observable market based inputs vs. less unobservable inputs that cannot be corroborated by observable market data in the derivation of accounting estimates;
- the audit work for those disclosures which are derived using fair value accounting estimates e.g. under IFRS 7; and
- which audit approach is appropriate and when.

Given the likely further developments in fair value reporting over the next few years , we suggest that the IAASB should consider undertaking a fuller review of the ED, utilising appropriate expertise, to develop additional guidance to ensure a consistent approach to audit in this area.

We are also aware that the current ED is very long and might be regarded as rather unwieldy. We would encourage the Board to revisit the ED after the clarity project is completed to identify whether it could be restructured in a way that, while providing sufficient guidance in the application material, enables it to be accessible and easy to follow.

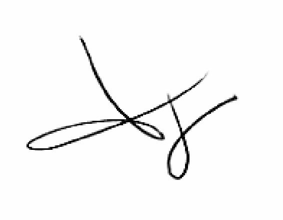
In the interim, in the attached appendix, we provide some specific suggestions where additional guidance regarding models and fair value estimates could be added to the ED.

In the attached appendix we also provide answers to the specific questions raised in the guide for respondents.

Our comments were coordinated by our Expert Group on Financial Information (EGFI), and especially by its Subgroup on Auditing, which is under the direction of Pat Sucher from the FSA, UK.

If you have any questions regarding our comments, please feel free to contact the chairman of EGFI, Arnoud Vossen (+31.20.524.3903) or Miss Pat Sucher (+44.20.7066.5644).

Yours sincerely



Danièle Nouy
Chair

Questions on the proposed redrafted ISA

1. Is the objective to be achieved by the auditor, stated in the proposed revised and redrafted ISA, appropriate?

We believe the objective is appropriate.

2. Have the criteria identified by the IAASB for determining whether a requirement should be specified been applied appropriately and consistently, such that the resulting requirements promote consistency in performance and the use of professional judgement by auditors?

We are not fully convinced that Paragraph 13 of the proposed ISA and its associated application material (paragraphs 52-85) is sufficiently robust or focused enough to promote consistency in performance and the appropriate use of professional judgement. Therefore, we recommend the following changes be made to paragraph 13:

- The introduction of the paragraph should be reworded to be more direct, e.g. 'In responding to the assessed risks of material misstatement, as required by ISA 330 (Redrafted), the auditor shall undertake one or more of the following based on his evaluation of the nature of the accounting estimate.
- A requirement should be added for the auditor to determine which estimates are derived, to a large extent, from unobservable inputs that cannot be corroborated by observable market data (e.g. some valuation models with a large number of entity specific inputs), and those that arise from observable market based inputs.
- The criteria in paragraph A52 are so important that, suitably modified, they should be part of the requirements in paragraph 13.

With respect to the requirements under paragraph 13, there needs to be more guidance about what factors need to be taken into account for an auditor to undertake a particular response. Application material A 52, which provides some guidance here, needs greater clarification over what criteria should be used to decide which audit approach to take under paragraph 13. As an example, the first bullet point in A 52 discusses the nature of an accounting estimate in terms of whether it arises from routine or non-routine transactions. We would suggest other criteria could be used here (e.g. whether the estimates have been derived using models and the types of inputs to those models).

3. What comments do respondents have on the proposed combination of ISAs 540 and 545, its effect on the content of the ISA, and the proposed withdrawal of ISA 545?

We welcome the proposed combination of ISAs 540 and 545. We found the mapping documents which illustrated how the contents of ISA 545 have been bought forward into ISA 540, very helpful.

We also note that it is stated that the combined ISA has been updated to include guidance on certain relevant fair value auditing considerations that are not addressed at present in extant ISA 545. However, as noted in our covering letter, we believe there needs to be some more practical guidance about what an auditor should undertake in relation to the audit of fair value accounting estimates where models are involved.

Observable and unobservable inputs and models

We do not believe the proposed ISA has enough coverage of the different audit techniques necessary for auditing accounting estimates where models have been used to generate the estimates (particularly fair value estimates).

We believe more emphasis should be placed on auditing the internal controls involved in accounting estimates, particularly with respect to fair value estimates when the valuations are based on the use of models, since in those cases, the auditor cannot corroborate the entity's own data directly against observable market inputs. It is therefore critical for the auditor to understand and assess the adequacy of controls surrounding the development of model based fair value estimates.

In addition, we believe it would aid consistency of auditor performance if a distinction was made in the structure of ISA 540 between the audit work on estimates derived, to a large extent, from unobservable inputs that cannot be corroborated by observable market data, and the audit work on those derived to a large extent from observable market based inputs.

There should be additional application material covering the auditor's consideration of models used for valuation of estimates. Such material should cover whether these are models which are generally accepted by and frequently used in the respective industry, or whether these models are self-developed by the entity and particular/specific to it. There could then be additional guidance on the assessment of the adequacy of controls around such models.

As an example of additional coverage regarding models, paragraph A 65 could be redrafted to include more detail. Though the following suggestion is quite extensive, it does capture many of the issues for auditors where models have been used to determine fair value.

A65

In some cases, particularly when determining fair value, management may make the accounting estimate by using a model. Matters that the auditor may consider in such circumstances include, for example, whether:

- The model is appropriate in relation to the business, industry and environment in which the entity operates, and to the specific asset or liability being measured.
- There are formal model development and validation policies and procedures. The staff involved in model validation is independent of the revenue generating business units that use the model.
- The model is adequately documented. The documentation describes the model's intended applications and limitations, identifies key model parameters and assumptions, and describes validation analysis performed.
- The model, including any changes to it, is validated by an independent unit prior to usage, with periodic reviews to ensure it is still suitable for its use. Validation includes evaluations of:

- the model's theoretical soundness and mathematical integrity;
- the consistency of model assumptions with market practices;
- sensitivity analyses performed to assess the impact of variations in model parameters on fair value; and
- the appropriateness of model inputs.

- The model is back-tested against actual transactions, when applicable.
- The same validation protocols apply for vendor models. Validations are conducted by a party independent of the model purchaser.
- Model revisions are performed in a controlled environment by authorized individuals following standard change control procedures.
- Inputs to the model are based on observable market data where applicable, and validated by an independent group. When unobservable inputs are utilized, the model is periodically calibrated and tested for its validity based on observable market data.
- In case the fair value estimates are adjusted for model uncertainty, the adjustments are approved by an independent financial control group and are consistent with the assumptions market participants would use in pricing the asset or liability.

Disclosures

There is also very little coverage of the audit work on disclosures that involve accounting estimates. As an example, for some of the disclosures under IFRS 7, as well as assessing whether the disclosure is adequate, the auditor has to understand the risk measurement methods adopted by management and evaluate whether they have been applied reasonably.

4. Is it appropriate to include in this ISA documentation requirements on the reasonableness of accounting estimates that give rise to significant risks and indicators of management bias?

We are not clear why there is a particular need for clarification in this ISA 540, and none in ISA 610. However, in principle, we have no objection to the inclusion of specific documentation requirements in individual ISAs as long as the rationale is clear and it is does not undermine the principles for documentation laid out in ISA 230.

Other comments on the application material

In line with our comments about the need for additional coverage regarding specific aspects of the audit of fair value estimates, we provide some examples below where we believe some additional guidance would be helpful. However, this is not an exhaustive list, and we believe a more substantial review is necessary which would indicate where more guidance would be appropriate.

Background/ identifying risks stage

A 24 - covers models, but not enough on what is the model, how inputs and the model itself should be assessed, selection of the model, and consistency of use of models. There also should be more guidance on the need to assess the controls over the inputs to the models, such as management sign off, annual reviews of the model to ensure it is still appropriate, and the controls to ensure the consistency and integrity of the model.

A 34 - should highlight the limitations of ‘back-testing’ fair values at subsequent measurement dates. This is a critical point that should be given more prominence and/or reinforced earlier in the document. It is also relevant to the audit work in paragraph 13a.

Identifying and assessing risks of material misstatement

A 38 - should also cover the extent to which the estimates are based only on non-observable inputs.

A 39 - add a bullet specifically on fair value: “Fair value estimates for which there are no observable market inputs and which rely heavily on models or other subjective inputs.”

Responses to the assessed risks of material misstatement

A 65 – see above for comments.