IAASB exposure draft ISA 540 (revised and redrafted), Auditing accounting estimates, including fair value accounting estimates, and related disclosures and proposed withdrawal of ISA 545, Auditing fair value measurements and disclosures

Dear Mr Sylph

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on your recent exposure draft. The Committee has a strong interest in high quality and independent audits of banks and has carefully analysed the proposals captioned above.

We appreciate the efforts of the International Auditing and Assurance Standards Board (IAASB) in revising and redrafting the auditing standards to improve clarity of the language within the standards to more clearly describe the responsibilities of the professional accountant. Additionally, we agree with the IAASB's decision to provide guidance on audits of all estimates in one standard, as opposed to providing separate guidance when estimates involve fair value measurements. The principles for auditing estimates should be consistent regardless of whether the estimates are based on fair value measurements or based on other types of measurements. However, fair value estimates require greater scrutiny on the part of the auditor, particularly when such estimates are derived through the use of models. In our view, the proposed ISA 540 does not sufficiently address the additional audit requirements that are necessary to audit fair value estimates.

We recommend that the IAASB extend the estimated timeframe for revision of ISA 540 until these additional principles are drafted and included in the revised standard. For this purpose, the Committee recommends that the IAASB convene a working group including risk management, financial instrument, and valuation experts. This working group could conduct research and, where possible, develop sound practices guidance on auditing methods and procedures for testing fair value estimates reported or disclosed in financial statements, particularly those that contain significant amounts of illiquid financial instruments (eg financial statements of banks). Other working group representatives could come from banks, audit firms, standard setters, and other major market participants. Since the
Committee is able to draw on staff resources with extensive knowledge regarding evaluation of financial instrument valuations and estimates derived from models, we could provide expertise for such a working group.

However, if the IAASB does not choose in the short term to conduct a more thorough review to address these issues, we include in the appendix some suggestions where additional guidance material should be included, as a minimum, in the ISA to address this gap. We also suggest that the IAASB should keep this ISA under review for a more fundamental revision when its clarity project is completed.

Please find our detailed comments in the attached appendix. These comments have been prepared by the Committee’s Accounting Task Force, chaired by Sylvie Mathérat, Director of the Commission Bancaire in France, and have been approved by the Committee. The Committee trusts that you will find its comments useful and constructive.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Marc Pickeur, who chairs the Audit Subgroup of the Accounting Task Force (+32 2 220 5253), or Linda Ditchkus at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely

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Appendix

Basel Committee comments on IAASB exposure draft ISA 540 (revised and redrafted), Auditing accounting estimates, including fair value accounting estimates, and related disclosures, and proposed withdrawal of ISA 545, Auditing fair value measurements and disclosures

1. Introduction

The Basel Committee on Banking Supervision (the Committee) has a strong interest in high quality and independent audits of banks and has carefully analysed the proposed revised and redrafted International Standard on Auditing (ISAs) pertaining to auditing accounting estimates, including fair value accounting estimates, and related disclosures. We are concerned about whether this ISA provides sufficiently comprehensive and robust guidance on the auditing of fair value estimates and disclosures. In particular, we question whether there is sufficient guidance on:

- the audit procedures to be undertaken when there are not clear observable market data and models have been used to generate an accounting estimate;
- the differential audit work involved in assessing observable inputs to the derivation of accounting estimates and assessing less independently verifiable management (ie unobservable) inputs; and
- the audit work for those disclosures that an entity prepares using fair value accounting estimates, eg under IFRS 7.

The Committee would like the proposed standard to provide more guidance on the auditing procedures for addressing relevant controls surrounding fair value estimates, such as independent model validation and price verification processes. In addition, greater emphasis should be placed on auditing the valuation methods used to arrive at fair value estimates. We believe a review and possible rewrite would aid clarity and assist auditors in dealing with potential changes in financial reporting, particularly if the ISA were restructured to focus on auditing accounting estimates where:

- models are not used to generate the estimates; and
- models are used to produce the estimates.

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1 The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, which was established by the central bank Governors of the Group of Ten countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. It usually meets at the Bank for International Settlements in Basel, where its permanent Secretariat is located.
The accounting estimates where models are used to produce the estimates could then be divided into the different audit risks and therefore audit procedures associated with those inputs to models that are entity specific (ie unobservable) and those that are market specific (ie observable).

Recently, there have been significant developments related to fair value estimates for financial accounting. For example, a discussion paper was released in November 2006 to solicit views related to an international financial reporting standard on fair value measurements. Additionally, the IASB’s and FASB’s joint project to create a conceptual framework is considering appropriate alternatives for measurement, including measurements at fair value. The outcomes of these ongoing and evolving projects may require different audit requirements, with respect to audits of fair value estimates, than the ones within the proposed ISA. Therefore, we suggest the ISA should be comprehensively reviewed, as a priority, over the next two years.

In December 2003, the Group of 30 issued a report entitled “Enhancing Public Confidence in Financial Reporting” (G30 Report). The Committee agrees with the findings of that report, which suggest that accounting data should be designed to provide reliable and relevant information regarding the economic and financial condition of individual business entities. The G30 Report included 17 best practices, which addressed governance, control, price verification, and internal and external audit practices that can help assure more reliable fair value estimates by banks and other major market participants. The IAASB could look to the concepts within these sound practices to ensure the principles of this ISA fully address relevant audit requirements.

In addition, the Committee recommends that the IAASB seek input from various sources to ensure the principles for auditing estimates involving fair value measurements are sufficiently robust. For example, a working group of risk management, financial instrument, and valuation experts could be convened with the goal of researching and, where possible, developing reasonably specific sound practices audit guidance on appropriate methods and procedures for testing fair value estimates for illiquid instruments, which comprise a significant portion of bank assets. If the IAASB agrees to convene such a group and since this is an area of particular concern to us, we would be very willing to provide our expertise for any substantial revision to the ISA or development of other audit guidance. Other working group participants could include representatives from banks, audit firms, standard setters, and other major market participants.

The remainder of this appendix highlights certain issues, questions and suggestions for the Board’s consideration. In this regards, the comments in section 2 are in response to the request for specific comments in the explanatory memorandum and Section 3 contains specific comments on the application and other explanatory material and some additional specific comments.

The Committee appreciated the publication of the supplemental mapping information, which provided explanations for decisions regarding requirements and application materials and changes to the proposed text.

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2 An international body of leading financiers and academics, with an objective of deepening the understanding of economic and financial issues and examining consequences of decisions made in the public and private sectors related to these issues.
2. Responses to the IAASB’s questions

Redrafting of ISA 540 (revised)

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

The objective requires auditors to ‘obtain sufficient appropriate audit evidence about whether the accounting estimates, including fair value accounting estimates, and related disclosures in the financial statements are reasonable in the context of the applicable financial reporting framework’. As currently written, the Committee believes that 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 judgment by auditors?

As mentioned in the introduction, the Committee believes the exposure draft can be improved by incorporating auditing procedures addressing relevant controls surrounding fair value estimates, such as independent model validation and price verification processes. In addition, more emphasis should be placed on auditing the controls involved in making accounting estimates, particularly with respect to fair value estimates when the valuations are based on unobservable inputs or the reporting entity’s own data. Also, more emphasis should be placed on auditing the overall valuation methods used to arrive at fair value estimates.

When a fair value estimate is based on the reporting entity’s own data and the auditor cannot verify these data directly against observable inputs, it is critical for the auditor to understand and assess the adequacy of controls surrounding the development of the estimate. We recommend that these suggestions be added to the proposed ISA (ie possibly as requirements), and examples are provided in the following text.

We do not believe that paragraph 13 of the proposed ISA and its associated application material (paragraphs A52-A85) are sufficiently strong or appropriately focused to promote consistency in performance of audit requirements and the appropriate use of the auditor’s professional judgement. We recommend the following changes be made to paragraph 13 to make it more robust:

- The introduction to the paragraph should be reworded to be more direct, eg ‘In responding to the assessed risks of material misstatement, as required by ISA 330 (Redrafted), the auditor shall evaluate the nature of the accounting estimate by undertaking one or more of the following, where appropriate:’.

- A requirement should be added for the auditor to determine which estimates arise from management controlled variables (ie unobservable inputs), and those that arise from market (independent) variables (ie observable inputs).

- The criteria in paragraph A52 are critical and should be part of the requirements in paragraph 13, after being suitably modified.

To improve clarity, there should be more guidance about when an auditor should undertake a particular response under paragraph 13.

The Committee suggests making revisions to paragraphs 13(b) and 13(c) to incorporate the increased use of fair value models, particularly in industries where fair values are extensively used such as in banking and insurance institutions. In addition, the Committee feels that
related paragraphs A60 and A73 should be modified in order to clarify when to use paragraph 13(b) or 13(c).

In paragraph 20, the first sentence should be rephrased to add ‘where appropriate’ after written representations.

**Combination of ISAs 540 (revised) and 545**

1. **What effect has the combination of ISAs 540 (revised) and 545 had on the content of the ISA, and the proposed withdrawal of ISA 545?**

**Combination of the ISAs**

The Committee commends the IAASB for combining the two ISAs and supports the combination. However, we note a few cases below where there may not have been adequate incorporation of certain aspects of ISA 545 into revised ISA 540:

- ISA 545, paragraph 22 - ‘The auditor should obtain audit evidence about management’s intent to carry out specific courses of action and consider its ability to do so, where relevant to the fair value measurements and disclosures under the entity’s applicable financial reporting framework.’ The requirement for the auditor to obtain audit evidence concerning management intent with regard to fair value disclosures does not appear to have been carried over sufficiently to this ISA. Paragraphs A12 and A71 provide some discussion, but we believe it could be clearer.

- ISA 545 paragraph 65 – This paragraph relates to ‘communication with those charged with governance.’ Despite the argument put forward in paragraph 11 of the basis for conclusions for not incorporating a communication requirement in revised ISA 540, we believe a cross reference to ISA 260 is necessary.

**Guidance on fair value considerations**

The proposed ISA does not sufficiently cover the audit requirements and considerations necessary for auditing accounting estimates where models have been used to generate the estimates (ie particularly for fair value estimates). Furthermore, we believe the proposed ISA does not appropriately describe unique audit risks associated with audits of models nor does it specifically describe techniques to audit verifiable inputs or less verifiable management inputs for accounting estimates.

Paragraph A65 of ISA 540 (revised and redrafted) does not sufficiently identify the matters that auditors may consider when auditing accounting estimates generated by models. As mentioned in our introductory remarks, the IAASB should provide more guidance on auditing procedures for addressing relevant controls surrounding fair value estimates, such as independent model validation and price verification processes. If the IAASB decides not to immediately conduct a more thorough review and re-drafting process to address these issues, the application material in paragraph A65 should, at a minimum, include a definition of the term ‘model’, address the scope of the ISA with respect to estimates derived from models, and incorporate the following detailed modifications:

‘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.

• The entity has formal model development and validation policies and procedures and the entity’s staff involved in model validation is independent of the revenue generating business units that use the model.

• The model is adequately documented and 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 group prior to usage, with periodic reviews to ensure it is still suitable for its intended 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 entity applies the same validation protocols for models purchased from vendors. Validations are conducted by a party independent of the business units that purchased or use the model.

• Model revisions are performed in a controlled environment by authorised individuals following standard change control procedures.

• Inputs to the model are based on observable market data where applicable, and validated by an independent party. When unobservable inputs are utilised, the model is periodically calibrated and tested for its validity based on observable market data where applicable.

• Adjustments made to fair value estimates for model uncertainty are approved by an independent financial control group and are consistent with the assumptions market participants would use in estimating the fair value of the asset or liability.

2. **Have the special considerations in the audit of small entities and public sector entities in relation to fair value accounting estimates been dealt with appropriately in the proposed revised and redrafted ISA 540?**

No comment.

Audit documentation

1. **Respondents’ views are sought on the inclusion of the specific proposed documentation requirement in ISA 540 (revised and redrafted), having regard to proposed ISA 230 (redrafted).**

In principle, we have no objection to the inclusion of specific documentation requirements in individual ISAs, including ISA 540, as long as the rationale is clear and the inclusion does not undermine the principles for documentation laid out in ISA 230.
3. Additional specific comments

Comments on the application and other explanatory material

As the Committee noted in the introduction to this letter, we do not believe there is adequate coverage of the audit procedures when models have been used to generate accounting estimates. The Committee therefore recommends making changes to paragraphs of ISA 540 (revised and redrafted) as follows:

In paragraph A21, we recommend changing the first bullet to reflect steps management should perform with respect to fair value estimates by adding the italicised text as follows:

‘sselecting appropriate accounting policies and prescribing estimation processes, including appropriate estimation or valuation methods and appropriate independent model validation and price verification methods.’

In paragraph A24, we suggest adding more descriptive information about controls over models. For example, text could be added to specify: what the model is designed to estimate, how inputs and the model itself should be assessed, selection of the model, and consistency of use of models. Additionally, examples could be added to describe 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. Furthermore, the role of internal audit in validating the model could be explained.

Paragraph A24 could also be enhanced by providing a few more detailed examples of controls, such as:

‘For fair value estimates in large credit institutions, there should be an independent estimate function, staffed with individuals whose remuneration is not in any way tied to the structured products sold by the institution.

Assessment of the other sources of market data (eg there may be major discrepancies between the different sources of market data for less liquid items, which may indicate that the reliability of the market data is also questionable).’

A new paragraph after paragraph A24 should be added to indicate that auditors may derive greater comfort with an accounting estimate (including a fair value estimate) if the estimate is used for other internal management purposes and not exclusively for accounting estimates reported or disclosed in the financial statements, or if the process by which the estimate is derived is used to make management decisions, not solely to arrive at estimates for reporting or disclosure purposes.

Paragraph A29 should emphasise that when management has not changed the method for making an accounting estimate, the auditor should confirm that the method remains appropriate.

Paragraph A30 could be enhanced by adding a bullet, after the first bullet, specifically on fair value estimates. Suggested text is:

‘Whether management has clearly identified and analysed unobservable inputs that impact fair value estimates.’

Paragraph A34 should highlight the limitations of ‘back-testing’ fair values at subsequent measurement dates. This critical point should be given more prominence and/or reinforced earlier in the ISA.
Paragraph A38 should also cover the extent to which the estimates are based only on non-market (verifiable) factors such as management intent.

Paragraph A39 would be enhanced by adding a bullet specifically on fair value estimates, for example:

‘Fair value estimates for which there are no observable inputs or which rely heavily on models or other subjective inputs.’

The first sentence of paragraph A58 could be made more proactive by modifying the text as follows:

‘Even if the auditor decides not to undertake this approach, the auditor is expected to comply with ISA 560 (redrafted), Subsequent events’

Paragraphs A76-A85 could provide more useful guidance by including information about when the auditor should develop a range rather than a point estimate.

Paragraph A108 would be enhanced by adding a bullet specifically on fair value, such as:

‘Use of an entity's own data for fair value estimates when observable market data exists.’

**Comments on disclosures**

The audit work involved in assessing the adequacy of financial statement disclosures is not sufficiently developed in the proposed ISA. While the ISA includes guidance for audits of disclosures with high estimation uncertainty, the ISA does not sufficiently cover audits of disclosures of market price risk information that is required by IFRS 7 (ie where accounting estimates and modelling may be involved).

**Other specific comments**

To the extent possible, the current Appendix on *Fair value measurements and disclosures under different financial reporting frameworks* should be incorporated or cross-referenced into the requirements and applications of ISA 540 (revised and redrafted).

In addition, it may be worthwhile to include a discussion of approaches to model validation and price verification as an Appendix.

The Committee recognises that as a result of the revisions to this ISA, certain International Auditing Practice Statements (eg IAPS 1012 *Auditing derivative financial instruments*) are likely to require amendments. We recommend that the IAASB include such a project on its agenda.