



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Agenda Item

4

Committee: IAASB

Meeting Location: New York

Meeting Date: September 13–17, 2004

Accounting Estimates

Objectives of Agenda Item

To review draft wording of the revised proposed revised ISA 540, “Auditing Accounting Estimates and Related Disclosures (Excluding those Involving Fair Value Measurements and Disclosures)”.

In view of the significant number of changes made to the previous draft presented to the IAASB, at its April 2004 meeting, the presentation and discussion of the revised proposed exposure draft will be based on the clean copy (Agenda Item 4-A).

Task Force Members

The Task Force comprises members of both the IAASB and the Auditing Practices Board of the United Kingdom and Ireland. The members of the Task Force are:

Philip Ashton (Chair)	IAASB member and former APB member
Jon Grant	APB member and IAASB technical advisor
Edmund R. Noonan	Former IAASB member
Andrew Palmer	Former APB member
David Thomas	APB Member
Gérard Trémolière	IAASB Member

Professor William R. Kinney Jr., of the University of Texas at Austin, attends meetings of the Task Force at the invitation of the IAASB.

Activities Since Last IAASB Discussions

The Task Force has met twice on May 17, and July 26/27, 2004 to consider the comments it had received at the April meeting of the IAASB and the June meeting of the Consultative Advisory Group. Arising from those meetings revisions have been made to the proposed exposure draft of a revised ISA 540.

Significant Changes Made in Response to the Comments of IAASB and CAG

RANGES

At its April meeting the IAASB voted on two issues that are related to ranges. The IAASB concurred with the Task Force’s position that there is not a misstatement if management’s estimate falls within a range of reasonably possible outcomes, with the proviso that such a range should also be of equally

possible outcomes. The discussion of ranges has been amended to reflect this decision. The IAASB also decided that if an accounting estimate moves within the range from period to period, with no justification, that this gives rise to a misstatement rather than bias.

Changes arising from these decisions can be seen in paragraphs 55, 56, 84, and 86 to 88.

CATEGORIES OF MISSTATEMENTS

The categories of misstatements have been amended to reflect those used in the latest draft of [Proposed revised] ISA 320, “Materiality in the Identification and Evaluation of Misstatements”. The new classification system is:

- (a) Known misstatements;
 - (i) Misstatements of fact;
 - (ii) Misstatements involving subjective decisions; and
- (b) Likely misstatements. (See paragraph 80 et seq)

It is important to understand the interrelationship between ISAs 320 and 540 with respect to misstatements. ISA 540 requires the auditor to identify misstatements but does not require an evaluation of them. Standards and guidance relating to the auditor’s evaluation of the effect of the misstatements on the financial statements are set out in ISA 320. This is explained in paragraph 79.

MEASUREMENT OF MISSTATEMENTS

At the April 2004 IAASB some Board members expressed the view that the proposed exposure draft was inconsistent in its measurement of certain misstatements. The April draft proposed that if an accounting estimate was within a range of reasonably possible outcomes that there was no misstatement. However, if the estimate was outside the range it was suggested that the misstatement might be measured to the mid-point of the range. To be consistent it was suggested, by some Board members, that the misstatement in the latter case should be measured to the nearest point of the range.

The revised draft has been amended such that where an estimate falls outside the range, the misstatement is measured to the nearest point in the range (see paragraph 85). The difference between the nearest point in the range and the mid point of the range is considered further under the heading of “bias” see discussion below and in paragraph 92(b) of the draft.

Where there is an unjustified change in location of an accounting estimate within the range from one period to another, the misstatement is measured as the difference between the accounting estimate made by management and what it would have been had the same location in the range been used (See paragraph 88).

INDICATORS OF BIAS

Management bias, with respect to accounting estimates, arises when the selection of an accounting estimate (by management) from a range of reasonably possible outcomes is not neutral. With respect to a range of reasonably and equally possible outcomes there is a rebuttable presumption that the mid-point of the range is free from bias and therefore neutral. This is explained in paragraph 91.

The section on bias has been rewritten with a greater emphasis on the quantification of bias. As explained in paragraph 92 of the draft, bias can only arise in those circumstances where:

- (a) An accounting estimate falls within a range of reasonably and equally possible outcomes; and
- (b) The applicable financial reporting framework does not specify which point in that range should be recognized.

The inter-relationship between misstatements and bias is further illustrated in Appendix 2 of the draft. As is the case with misstatements, the evaluation of bias is dealt with in ISA 320, and this is discussed in paragraph 93 of the draft.

The example of an indicator of bias in paragraph 92(b) arises from earlier IAASB discussions of the measurement of misstatements where management's estimate is outside the range (see above). As it is not entirely clear that this bias can be ascribed to management, the heading of this section of the proposed ISA is expressed in terms of "indicators of bias" rather than "management bias".

WORDING OF THE OVERARCHING STANDARD

The overarching standard is set out in paragraph 3. The inclusion of the last three words "and are reasonable" was discussed by IAASB in April 2004. The suggestion of some Board members was that these last three words should be "or are reasonable". The Task Force considered this and decided that the use of the word "or" was inappropriate and instead had decided to delete the reference to "reasonable" in the over-arching bold letter paragraph.

However, discussion with the ISA 700 Task Force indicated that the proposed wording of the auditor's report is to include reference to "reasonable estimates". That Task Force takes the view that if the concept of reasonable estimates is not explicitly set out in a bold letter paragraph in ISA 540 that the necessary hooks will not be in place to support ISA 700.

The ISA 540 Task Force has, therefore, reinstated these words pending a final decision by IAASB that takes account of the need for hooks in ISA 540 to support ISA 700.

It should be noted that the view expressed by some that reference to reasonable is unnecessary, because the thought is subsumed by reference to the applicable financial reporting framework, might be considered disingenuous. This is because accounting frameworks frequently do not specify the precise way in which an accounting estimate should be measured. They explicitly state that the use of "reasonable estimates" is an essential part of the preparation of financial statements. Therefore, the requirement for the auditor to evaluate whether an accounting estimate is measured in accordance with the applicable financial reporting framework effectively requires the auditor to evaluate whether an accounting estimate is reasonable.

CHANGES IN TERMINOLOGY – MEASUREMENT RELIABILITY

In earlier drafts of the proposed ED, the expression "measurement uncertainty" was used in the context of the reliability of the measurement of an accounting estimate. At the April 2004 Board

meeting the IAASB directed the Task Force to use the expression “estimation uncertainty” so as to bring ISA 540 in line with IAS 1 “Presentation of Financial Statements (revised)”. Some Board members have pointed out that the term “estimation uncertainty” is a mixed (and therefore confusing) metaphor in the context of, for example, the IASB’s “Framework for the Preparation and Presentation of Financial Statements”.

The IASB’s Framework has two recognition criteria:

- (a) The probability of future economic benefit. (This refers to the degree of uncertainty that the future economic benefits will flow to or from the entity); and
- (b) The item has a cost or value that can be measured with reliability.

As the second criterion is the primary subject matter of ISA 540 the term “estimation uncertainty” has been replaced with the term “measurement reliability”. In this way it is considered by some that ISA 540 will be more understandable in the context of the IASB and other accounting frameworks.

The effect of this change permeates the entire draft. However the effect can be seen most clearly in the descriptors of the categories in paragraph 35. Members of IAASB may wish to consider whether the new descriptors of the categories are, in fact, an improvement on those used in earlier drafts. Arguably the view of the framework described above is overly pedantic and it may be better to revert to “estimation uncertainty” which term has the benefit of being used in IAS 1 (revised).

CHANGES IN TERMINOLOGY- TOLERABLE ERROR

The draft considered by the IAASB in April adopted the concept of “tolerable misstatement” (now described as “tolerable error”) from ISA 320. This concept was used as the measure for evaluating whether there should be disclosure of the fact that an accounting estimate has been selected from a wide range of possible outcomes. Wide was defined as being greater than tolerable error. The Task Force considers that materiality, rather than tolerable error should be the measure of wide when evaluating whether a disclosure should be made. Tolerable error is an audit planning tool rather than an audit evaluation tool.

Other Matters for the Attention of the IAASB

COMMENTS OF THE SMP TASK FORCE

An earlier draft of the proposed revised ISA has been reviewed by the SMP Task Force. Their comments, and the responses to them are provided in Agenda Paper 4-C.

Material Presented

Agenda Paper 4-A Draft exposure draft – clean
(Pages 1651-1676)

Agenda Paper 4-B Draft exposure draft - mark-up (showing changes from the draft
(Pages 1677- 1710) presented at the April 2004 IAASB meeting)

Agenda Paper 4-C Response to Comments of the SMP Task Force
(Pages 1711-1712)

Action Requested

The IAASB is asked to review and comment on the proposed exposure draft to enable the Task Force to prepare a revised proposed exposure draft for approval for issue.

[Blank Page]