Accounting Estimates Involving Measurement Uncertainty

Agenda Item 2-A
Background

- Project to revise ISA 540, *The Audit of Accounting Estimates*
- Joint Project of IAASB and the Auditing Practices Board of the United Kingdom & Ireland (APB)
- Close link to IAASB materiality project
Reasons for revision - 1

• Approach of extant ISA 540 is largely procedural and inconsistent with recently published IAASB exposure drafts of proposed Audit Risk Standards

• Align approach of ISA 540 with approach of ISA 545 “Auditing Fair Value Measurements and Disclosures” issued by IAASB in 2002
Reasons for revision - 2

- Align with developments in Accounting Standards
  - A number of accounting frameworks are considering requiring disclosure of sources of measurement uncertainty (e.g. IAS 1 revision)
Reasons for revision - 3

• Concerns about abuse of accounting estimates to support aggressive earnings management
  – Uncertainty about future outcomes often gives rise to a range within which an estimate might lie
  – Management can bias the results by changing the relative position of an estimate within a range (for example moving from aggressive to conservative)
  – Auditor’s difficulty is that, frequently, the greater the uncertainty the less audit evidence is readily available
Progress since October 2002

• Issues paper presented to IAASB (Dec. 2002)
• Informal discussions with IASB staff
• Academic input obtained from an acknowledged expert in the field
• Task Force reached broad agreement on framework for a revised ISA 540
• Coordination with Audit Materiality Task Force
Issues addressed by Task Force - 1

• Three categories of accounting estimates:
  1) Estimates not subject to measurement uncertainty (no judgment required and give rise to factual errors)
  2) Estimates subject to measurement uncertainty (uncertainty derives from need for judgment in assessing outcome of uncertain future events)
  3) Not possible to make an estimate because range of possible outcomes is too wide (the item is not recognised in the primary financial statements)
**Issues addressed by Task Force - 2**

- Encouraging auditors to seek audit evidence to circumscribe the range within which an estimate involving measurement uncertainty might fall
Issues addressed by Task Force - 3

- Determining what constitutes a “misstatement” of the financial statements
  - A misstatement would be the difference between the amount recognized in the financial statements and the auditor’s own estimate
Issues addressed by Task Force - 4

• Evaluating adequacy of disclosure of measurement uncertainty
  – Auditors should evaluate the adequacy of disclosure in the financial statements
  – Inadequate disclosure may lead to an emphasis of matter paragraph in the auditor’s report
Management bias

- Management may introduce bias into the financial statements by changing the stance they adopt towards the location of estimates, within the range, from one year to another
- Communicated to those charged with governance.
Timetable going forward

- IAASB reviews first draft of exposure draft at its July 2003 meeting
- Exposure draft issued by the end of 2003
- ISA ready for issuance by the end of 2004