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**Basis for Conclusions:
ISA 540 (Revised and Redrafted),
Auditing Accounting Estimates,
Including Fair Value Accounting
Estimates, and Related
Disclosures**

*Prepared by the Staff of the International Auditing and
Assurance Standards Board*



**International Federation
of Accountants**

**BASIS FOR CONCLUSIONS:
ISA 540 (REVISED AND REDRAFTED), AUDITING ACCOUNTING ESTIMATES,
INCLUDING FAIR VALUE ACCOUNTING ESTIMATES, AND RELATED
DISCLOSURES**

This Basis for Conclusions has been prepared by staff of the International Auditing and Assurance Standards Board (IAASB). It relates to, but does not form part of, ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures,” which was unanimously approved by the IAASB in December 2007.

Background

1. In December 2004, the IAASB issued an exposure draft of proposed ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures).” The comment period for the proposed ISA closed on April 30, 2005. The IAASB gave due consideration to the comments received and approved a “close off” document of ISA 540 (Revised) in the “old style” (i.e., following the extant ISA’s drafting conventions for ISAs) in September 2006.¹
2. Following agreement of the close-off document, ISA 540 (Revised) was to be redrafted in accordance with the IAASB’s Clarity conventions. The IAASB determined that matters of continuing relevance in ISA 545, “Auditing Fair Value Measurements and Disclosures,” should be revised and incorporated into ISA 540 (Revised) in order to form one combined ISA dealing with the audit of accounting estimates, including fair value accounting estimates.
3. The conventions used by the IAASB in redrafting ED-ISA 540, and the authority and obligation attaching to those conventions, are established in the amended Preface to International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services (Preface), approved by the IAASB in September 2006.²
4. An exposure draft of proposed ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures” was approved for publication in December 2006 (“ED-ISA 540”). At the same time, the IAASB issued a proposal to withdrawal ISA 545 as a result of the combination of ISA 540 (Revised) and ISA 545.
5. The IAASB discussed the project with its Consultative Advisory Group (IAASB CAG) on 4 occasions. The comment date for ED-ISA 540 was April 30, 2007. The IAASB received 44 comment letters from a variety of respondents, including regulators, IFAC member bodies, national auditing standard setters, government auditors, and firms. The

¹ The Basis for Conclusions: ISA 540 (Revised) and related close off document are available on the IAASB website at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069>.

² The amended Preface can be accessed at http://www.ifac.org/download/IAASB_Preface.pdf. Elements of the authority and obligation attaching to the Clarity conventions are currently being exposed as part of proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

IAASB revised ED-ISA 540 as a result of these comments. The following summarizes the more significant issues raised by respondents, and how the IAASB addressed them.

Combination of ISAs 540 and 545 and Withdrawal of ISA 545

6. Almost all of the respondents expressed support for the IAASB's decision to combine the close off document of ISA 540 (Revised) and ISA 545; IAASB CAG also supported this view. Respondents concurred that the principles for auditing estimates should be consistent regardless of the basis of measurement. Many respondents specifically commented that the requirements of the proposed ISA were applicable to both accounting estimates and fair value accounting estimates.
7. As a result of the approval of ISA 540 (Revised and Redrafted), the IAASB unanimously voted to withdraw ISA 545 when ISA 540 (Revised and Redrafted) becomes effective.³

Audit Documentation

8. Respondents were asked for their views on whether it was appropriate for a separate documentation requirement to be included in ED-ISA 540, having regard to proposed ISA 230 (Redrafted).⁴
9. Respondents were evenly divided on whether the separate requirement should be included or whether it was implicitly covered in ISA 230 (Redrafted). As the majority of the IAASB supported the requirement on the premise that individual ISAs should include specific documentation requirements for matters of importance in order to facilitate consistent application of the documentation principles in ISA 230 (Redrafted), the IAASB agreed to retain the requirement.
10. However, a slight modification was made to the requirement in ED-ISA 540 to include documentation about the disclosure of accounting estimates to align the requirement to the revised objective as discussed below. The words "if any" were also included in the requirement to document the indicators of possible bias, in reaction to respondent's concerns that an auditor would otherwise be required to document whether there had or had not been indicators of bias for each accounting estimate.

Objective of the ISA

11. The majority of respondents were of the view that the objective to be achieved by the auditor was appropriate. However, two respondents suggested that it would be appropriate to separate the objective of the ISA into two parts to emphasize the distinction between the auditor's need to determine whether the accounting estimates in the financial statements are reasonable and whether related disclosures are adequate in the context of the applicable financial reporting framework.

³ ISA 540 (Revised and Redrafted) will be effective for audits of financial statements for periods beginning on or after December 15, 2009.

⁴ ISA 230 (Redrafted), "Audit Documentation," as finalized and approved by the IAASB in September 2007.

12. The IAASB concurred with this view, and as a result, restructured the ISA to include a separate section dealing with requirements related to disclosures of accounting estimates. The IAASB believes the new presentation will emphasize the significance of disclosures especially in relation to fair values; it will also ensure that auditors are mindful that the same audit considerations apply both to accounting estimates disclosed in the notes to the financial statements and those that are recorded in the financial statements.
13. It was also recommended that the term ‘reasonable’ be eliminated and the objective focus on whether the estimates and related disclosures are ‘appropriately accounted for and disclosed in the context of the financial reporting framework and in the circumstances of the engagement,’ so as to avoid confusion with the term “reasonable assurance” in proposed ISA 200 (Revised and Redrafted).⁵
14. The IAASB understands the reasons for this comment, and accepts the importance of the accounting being in accordance with the framework. In the context of the measurement of estimates, however, the uncertainties involved often result in a range of possible values being appropriate. The audit of accounting estimates is therefore focused on whether the estimate is broadly correct, recognizing that there is inherent estimation uncertainty, rather than solely on whether they have been appropriately accounted for. The use of the word ‘reasonable’ is intended to capture both the concept of getting the number as right as possible, and doing so in accordance with the financial reporting framework when specified.

Coverage of Fair Value Auditing Issues

Additional Guidance on Fair Value Accounting Estimates within the ISA

15. Five respondents were of the view that ED-ISA 540 did not sufficiently address the additional audit requirements that are necessary to audit fair value accounting estimates and that the ISA should be expanded to cover more fair value specific topics. With the exception of one request for a new requirement, these respondents did not indicate that the proposed requirements were lacking; rather, they suggested additional application and other explanatory material to expand upon matters which they believed were important.
16. These respondents suggested that the proposed ISA should provide more guidance on the auditing procedures for addressing relevant controls surrounding fair value accounting estimates, and place greater emphasis on auditing the valuation methods used to arrive at fair value measurements. It was also suggested that additional application and other explanatory material be added to cover the auditor’s consideration of models used to measure an accounting estimate.
17. The IAASB accepted the point that fair value accounting estimates based on non-observable data and models are complex and have high estimation uncertainty. In particular, the IAASB noted that recent developments in the marketplace have raised awareness of the significance of fair value accounting estimates, and of the use of

⁵ Proposed ISA 200 (Revised and Redrafted), “Overall Objective of the Independent Auditor, and the Conduct of an Audit in Accordance with International Standards on Auditing.”

modeling in difficult market conditions. Indeed, many such fair value accounting estimates may be assessed as significant risks for audit purposes. Accordingly, the IAASB recognized that it was essential that the ISA included appropriate guidance to support application of the requirements in the context of such fair value accounting estimates.

18. However, the IAASB has sought to achieve an appropriate balance between regular accounting estimates and fair value accounting estimates. The IAASB has also tried to avoid the risk that the length and complexity of the standard might impair its understandability, if it were to contain too much material of limited or specialized application.
19. Consequently, the IAASB considered the suggestions by respondents and has included additional application and other explanatory material to ED-ISA 540 to provide examples to address fair value accounting estimates while remaining framework and industry neutral. In particular, the IAASB agreed to add a subsection on “Evaluating the Use of Models”⁶ as part of the auditor’s evaluation of the method used to make an accounting estimate when a model was used. The additional application and other explanatory material notes that the extent to which the considerations are relevant depends on the circumstances, including whether a model is one that is commercially available for use in a particular sector or industry, or a proprietary model. IAASB CAG was in agreement that the level of additional guidance included in the final ISA was appropriate in that it was not too industry-specific.

Additional Implementation Guidance for the Audit of Fair Value Accounting Estimates

20. Some members of the IAASB CAG supported the view that more guidance should be developed for the audit of fair value accounting estimates in addition to what has been included in the final ISA. The IAASB agreed and is currently consulting with a wide range of interested parties on how such guidance might be developed, what it might contain and how authoritative it should be.

Requirement to Determine Whether Estimates are Derived from Unobservable Inputs

21. It was suggested that a new requirement be added for the auditor to determine which fair value estimates are derived from unobservable inputs (in contrast to those that derived from observable market based inputs).
22. The IAASB did not agree that a new requirement was needed, since ED-ISA 540 contained a requirement (paragraph 8(c)) for the auditor to understand how management makes the accounting estimates (i.e., management’s process for making the accounting estimates).
23. In order to make the effect of the requirement clearer, the ISA now specifically requires (in paragraph 8(c)(i)) that the auditor understand the method, including where applicable the model, used in making the accounting estimate. Corresponding application and other explanatory material has been added to provide context to the requirement.

⁶ See paragraphs A74-A76 of ISA 540 (Revised and Redrafted).

Using the Work of an Expert

24. The issue most frequently raised by respondents related to the proposed new requirement in paragraph 12 of ED-ISA for the auditor to determine the need to use the work of an auditor's expert to obtain sufficient appropriate audit evidence regarding accounting estimates that give rise to risks of material misstatements. Most were of the view that this requirement would not comply with the criteria used in drafting ISAs, namely, that a requirement should be applicable in virtually all engagements.
25. Respondents suggested that the literal interpretation of the requirement is that, for every accounting estimate, irrespective of materiality, the auditor would be required to make a determination if an expert needs to be involved. Their view was that it would be highly unlikely that such a need exists for many regular accounting estimates, and accordingly, the ISA may impose an unwarranted obligation on the auditor.
26. Respondents recommended that this paragraph be redrafted, and some proposed that the material should be included as application and other explanatory material rather than a requirement. Others suggested that the requirement be limited to accounting estimates that give rise to significant risks of material misstatement.
27. The IAASB understood the concerns of respondents, and agreed that some changes to the wording of the requirement in ED-ISA 540 were necessary to maintain what was originally contemplated by both ISA 540 (Revised) and ISA 545, and that additional application and other explanatory material could be added to clarify the requirement.
28. Some respondents viewed the requirement as an elevation of the explanatory material in ISA 540 (Revised). ISA 540 (Revised) mentions that the auditor may decide to use an expert in developing a point estimate or a range to evaluate management's point estimate. The intent of the requirement in ED-ISA 540 was not to elevate matters in ISA 540 (Revised). Rather, it was to incorporate the bold letter requirement in extant ISA 545 that "the auditor should determine the need to use the work of an expert."
29. In including the requirement in ED-ISA 540, the IAASB was of the view that the requirement, while particularly relevant in the context of fair values, was also applicable to regular accounting estimates. This reflects, in part, the requirements in ISA 300 (Redrafted)⁷ and proposed ISA 220 (Redrafted)⁸ for the auditor to ensure that the engagement team consists of the appropriate personnel, including experts. In discussing the comments received on ED-ISA 540, the IAASB agreed that the requirement should be retained. However, the need for expertise may extend beyond that dealt with by proposed ISA 620 (Revised and Redrafted),⁹ which defines an 'auditor's expert' and may include the need for assistance from those who have specialized skills or knowledge in the field of accounting or auditing. This would include specialists within a firm such as those with special knowledge of industry or fair value accounting issues.

⁷ ISA 300 (Redrafted), "Planning An Audit of Financial Statements," paragraph 7(e).

⁸ Proposed ISA 220 (Redrafted), "Quality Control for an Audit of Financial Statements," paragraph [13].

⁹ Proposed ISA 620 (Revised and Redrafted), "Using the Work of an Auditor's Expert."

30. As a result, the requirement has been revised as follows in paragraph 14 of the ISA:
“In determining the matters identified in paragraph 12 or in responding to the assessed risks of material misstatement in accordance with paragraph 13, the auditor shall consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.”
31. The IAASB believes that changing the requirement to one of consideration rather than determination makes it clear that there is no formal determination required in every case. However, it retains the essential consideration of the need for an expert or other specialist thereby ensuring that auditors understand that there may be merit in making use of such skills. Further, the application material makes it clear that there will be many cases – indeed, the majority – where no additional expertise is required.

Responses to the Assessed Risks of Material Misstatement

32. A number of respondents were of the view that the level of detail in paragraphs 13(b) and 13(d) of ED-ISA 540 was inappropriate for a requirement and suggested that the wording be moved to application and other explanatory material. These requirements represented elevations from the close off document. The respondents were also of the view that the detail in paragraphs 13(d)(i) and 13(d)(ii) would not be appropriate in all cases, as the auditor would have already concluded on management’s assumptions in accordance with paragraph 13(b) of ED-ISA 540.
33. Two other respondents noted that paragraphs 13(b)(ii) and 14 of ED-ISA 540 would establish requirements for the auditor to assess management’s assumptions, and that this would only be applicable in situations in which the auditor decides to evaluate management’s process as opposed to developing the auditor’s own point estimate or range. One also believed that paragraph 14(b) of ED-ISA 540 seemed to require this evaluation for significant risks, and including it as an optional procedure in paragraph 13 may be confusing.
34. However, others believed that the requirement in paragraph 13 of ED-ISA 540 was not sufficiently strong or appropriately focused to promote consistency in performance of audit requirements and the appropriate use of the auditor’s professional judgment. One respondent in particular requested that more guidance be developed about when an auditor should undertake a particular response under paragraph 13 of ED-SA 540.
35. The IAASB decided to elevate the material in paragraphs 13(b) and 13(d) from the close off document in order to provide direction to the auditor which is necessary for consistent application and to achieve the overall objective. The IAASB does not agree with the respondents that this is over-prescriptive, as it focuses on important features that need to be considered when the auditor undertakes the specific procedures, and determined that this material should be included in the final ISA.
36. To address the request for more guidance about when an auditor should undertake a particular response under paragraph 13 of ED-ISA 540, the IAASB has included some

additional application and other explanatory material (see paragraph A60). However, the IAASB believes that the guidance in paragraphs A62 through A95 is otherwise sufficient.

Completeness and Validity Assertions

37. A question as to whether the completeness and validity assertions relating to accounting estimates were adequately addressed in the ISA was raised. The IAASB noted that paragraph 8(b), along with paragraph A17, addresses completeness through requiring the auditor to obtain an understanding of how management identifies the transactions, events and conditions that may give rise to the need for accounting estimates in the financial statements. Further, paragraph 18 of ISA 315 (Redrafted)¹⁰ deals with the understanding of the accounting system (which includes validity, accuracy and completeness of recorded transactions) and paragraph 24 of ISA 315 (Redrafted) requires the auditor to work at the assertion level, and provide for coverage of the assertions listed in paragraph A104 of ISA 315 (Redrafted), including existence, occurrence, validity and completeness. ISA 330 (Redrafted)¹¹ then requires procedures responsive to assessed risks. Additionally, ISA 560 (Redrafted)¹² is also intended to help with completeness. The IAASB did not believe there is anything specific that needs to be amplified in this topic-specific ISA that is not covered by a requirement in another ISA

Estimation Uncertainty

38. Concern was expressed that it would not be sufficient for the auditor to *consider* whether it is necessary for the auditor to develop a range with which to evaluate the reasonableness of an accounting estimate when an auditor has determined that management has not adequately addressed the risks of estimation uncertainty on the accounting estimates that give rise to significant risks. (See paragraph 15 of ED-ISA 540). It was suggested that the auditor may need to develop a range or take some other action; however, no specific examples of what other actions may be appropriate were given.
39. The IAASB considered this comment, and is not of the view that the requirement should be extended. The intent of this requirement is for the auditor, having already done detailed audit procedures as required by paragraphs 13 and 15 of the ISA, at least to consider the development of a range if management had not addressed estimation uncertainty. The auditor remains under an obligation under ISA 330 (Redrafted), as referred to in paragraphs 13 and 15, to obtain sufficient appropriate audit evidence.

¹⁰ ISA 315 (Redrafted), “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment.”

¹¹ ISA 330 (Redrafted), “The Auditor’s Responses to Assessed Risks.”

¹² ISA 560 (Redrafted), “Subsequent Events.” [ISA 560 (Revised and Redrafted), which was approved by the IAASB in December 2007, will be published when the Public Interest Oversight Board has confirmed that the IAASB has followed due process in its development. In the interim, respondents can access the text of the ISA at <http://www.ifac.org/IAASB/Meeting-Resource.php?MID=0093&type=Updated+Agenda.>]