

IAASB CAG PAPER



International Federation of Accountants

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Agenda Item

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Committee: IAASB Consultative Advisory Group

Meeting Location: Toronto

Meeting Date: September 11-12, 2006

Accounting Estimates

Objectives of Agenda Item

1. To provide a brief report back on the November 30-December 1, 2005 proposals of Representatives on proposed ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)” and on significant matters discussed at the March 2006 IAASB meeting.
2. To obtain the views of Representatives on the proposed “close off”¹ version of proposed ISA 540 (Revised) scheduled for approval by the IAASB at its September 2006 meeting.
3. To obtain the views of Representatives on the Task Force’s proposal to combine ISA 540 (Revised) and ISA 545, “Auditing Fair Value Measurements and Related Disclosures.”

November 30-December 1, 2005 CAG Proposals

Below are extracts from the minutes of the November 30-December 1, 2005 CAG meeting and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

Representatives’ comments	IAASB task force/IAASB response
Auditor-developed Range of Reasonable Outcomes	
Mr. Gutterman reported that some actuaries that were consulted on the wording of the proposed ISA noted that the term “range of reasonable outcomes” is technically incorrect and, from their perspective, incomprehensible. He suggested that the auditor focus on whether the estimate is reasonable, rather than the outcomes <i>per se</i> .	The Task Force and IAASB agreed that the term “range of reasonable outcomes” may be problematic and concluded that the ISA should eliminate this term; instead, it was agreed that the ISA should: (a) refer to the range developed by the auditor for purposes of evaluating the reasonableness of management’s point estimate as “the auditor’s range;”

¹ The term “close off” is used in the context of proposed standards currently under exposure. The intention is to revise the proposed standard based on comments received on exposure, and to obtain the IAASB’s agreement on the revised proposed standard before it is redrafted for clarity purposes. This step is referred to as “close off.” The next step is to expose the changes arising from redrafting the revised proposed standard in the clarity format.

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	and (b) describe the characteristics necessary of such a range for audit purposes in the explanatory material. The Task Force and IAASB were of the view, however, that it is necessary for the auditor to be satisfied that the outcomes within the range are reasonable, as a means to evaluate whether the estimate itself is reasonable. Refer to paragraphs 3(b) & 72-74 of proposed ISA 540 (Revised) (Agenda Item D.1).
Mr. Popham noted that the requirements and guidance on significant uncertainties in paragraph 80 of the proposed ISA, which restrict disclosure of uncertainty to that required by the financial reporting framework, are inconsistent with the proposed conforming amendments to paragraph 31 to ISA 570, "Going Concern" (noted in the Exposure Draft of proposed ISA 705, "Modifications to the Audit Opinion in the Independent Auditor's Report" and proposed ISA 706, "Emphasis of Matter Paragraphs and Other Matters Paragraphs"), which requires clear disclosure of significant uncertainties to the extent necessary for the financial statements not to be misleading.	The Task Force considered any possible inconsistencies and is satisfied that the wording proposed in the revised ISA does not present problems in this regard. Refer to paragraphs 88 and 89-92 of proposed ISA 540 (Revised) (Agenda Item D.1).
Mr. Rabine noted that the expectation of the public is often that the outcome of an estimate will not be materially different from the estimate as audited. He was therefore of the view that an audit model that focuses on a range of reasonable outcomes as a basis on which to evaluate the estimate would be ineffective in responding to the public's expectations.	The Task Force and IAASB are of the view that the outcome of an estimate may be materially difference from the estimate audited irrespective of the approach taken to auditing the estimate (i.e., development of a range or testing how management made the estimate); particularly when there is high estimation uncertainty surrounding the estimate. The proposed requirements and guidance pertaining to significant risks – in particular those relating to the recognition of the accounting estimates in the financial statements and disclosures of estimation uncertainty – are designed to focus on this inherent risk and to assist in minimizing the potential expectation gap. Refer to paragraphs 86-92 of proposed ISA 540 (Revised) (Agenda Item D.1).
Mr. Gutterman noted concern over the use of the phrase "as likely as not" in describing the process of	The Task Force and IAASB agreed that the phrase may have differing technical interpretations and

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narrowing the range of reasonable outcomes.	accordingly, have revised the wording of the process of narrowing the range. Refer to paragraph 72 of proposed ISA 540 (Revised) (Agenda Item D.1).
Point Estimates and Treatment of Differences as Misstatements	
Mr. Gutterman was concerned about the notion that an auditor is capable of developing a point estimate that is more reliable than that of management. Greater emphasis should be place on the auditor's use of ranges in general, an approach that would be more consistent with practice. Mr. Gutterman was also concerned that the guidance on the circumstances in which the auditor determines that a misstatement exists seems to imply that the identification and measurement of misstatements depends on the approach taken by the auditor in auditing the estimate and on the ability of the auditor to develop either a point estimate or a range. He suggested that the Task Force clarify the cases where the auditor is likely to arrive at either a point estimate or a range, including those circumstances where the financial reporting framework specifies that a particular point within a range is to be used as the point estimate.	<p>The Task Force and IAASB agreed with the points made. The proposed ISA therefore was revised to emphasize the varying use that the auditor may have in considering the use of ranges, and the circumstances which affect the ability of the auditor to make a point estimate as opposed to a range.</p> <p>The IAASB also shared the view that it is only in rare cases that the auditor will be able to narrow the range to a point where audit evidence indicates a point estimate that differs from the management estimate (in circumstances other than where there has been a factual error, such as an incorrect calculation). Accordingly, the IAASB agreed that the flow and wording of the explanatory guidance dealing with the development of a point estimate or a range should be revised to place greater emphasis on the development and narrowing of ranges. The IAASB also agreed that a corresponding change in emphasis is needed in the wording of the guidance dealing with the auditor's evaluation of the reasonableness of the accounting estimates and determining misstatements. Refer to paragraphs 66-67, 71 and 74 of proposed ISA 540 (Agenda Item D.1).</p>
Indicators of Possible Management Bias	
Messrs. Gislason and Gutterman noted that there is a broad spectrum of different forms of bias. It was suggested that emphasis should be place on intentional bias.	The Task Force and IAASB agreed with this point and accordingly, emphasis has been given to that intentional bias may be fraudulent in nature. Refer to paragraph 9 of proposed ISA 540 (Agenda Item D.1).
Considerations in the Audit of Small Entities	
Mr. Gislason suggested that further consideration be given to guidance dealing with those situations where	The Task Force and IAASB agreed that this is a general point of relevance, irrespective of the size of

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the estimation uncertainty associated with an estimate is so large in relation to the financial statements that it may affect the use of the going concern assumption.	the entity. Wording reflecting this has been incorporated into the proposed ISA. Refer to paragraph 40 of proposed ISA 540 (Agenda Item D.1).
Relationship of Proposed ISA 540 (Revised) and ISA 545	
Mr. Gutterman noted that Mr. Pickeur would encourage the IAASB to consider addressing the revision of IAPS 1012, "Auditing Derivative Financial Instruments" as part of the process of updating ISA 545.	See discussion of issues below.

Other Matters – Proposed ISA 540 (Revised)

RISK ASSESSMENT PROCEDURES AND RESPONSES TO RISKS OF MATERIAL MISSTATEMENT

At its March 2006 meeting, the IAASB noted that the proposed risk assessment procedure for the auditor to obtain an understanding of whether the method for making the accounting estimates has been applied consistently, and the basis for changes (if any) from the prior year, appears to go beyond the purpose of risk assessment procedures. Rather, it represents the type of procedure the auditor would perform when auditing an accounting estimate in response to the assessed risks of material misstatement. The IAASB agreed that the proposed risk assessment procedure should be redrafted to reflect the necessary understanding of whether there have been changes to management's process for making accounting estimates.

In addition, it was noted that the ISA appears to omit a requirement that drives the auditor to consider whether management has properly applied all the requirements of the applicable financial reporting framework relevant to the accounting estimate, as part of the auditor's response to the assessed risks. Accordingly, the IAASB agreed that the auditor should be required, in responding to the assessed risks of material misstatement, to:

- Determine, to the extent not already done, whether management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate; and
- Determine whether the methods for making the accounting estimates have been applied consistently, and the basis for changes, if any, in accounting estimates from the prior period.

Refer to paragraph 11 (c) and 42-45 of proposed ISA 540 (Agenda Item D.1).

Matters for Consideration by the IAASB CAG:

The Representatives are asked for their views on the proposed "close off" version of proposed ISA 540 (Revised) in Agenda Item D.1 in relation to the response to the November 30-December 1,

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2005 CAG proposals and the significant matters raised by the IAASB at its March 2006 meeting.

Proposed Combined ISA 540-545

In March, the IAASB asked the Task Force to identify an optimal solution to the issue of the interrelationship between ISA 540 (Revised) and ISA 545 such that standards and guidance on auditing fair values are dealt with simultaneously with the future exposure of ISA 540 redrafted in accordance with the clarity drafting conventions.

The Task Force's proposals, in summary, are as follows:

1. ISAs 540 (Revised) and 545 should be combined in one ISA (Combined ISA).
2. The scope of the Combined ISA should address the audit of accounting estimates, including those measured at fair value (that is, fair value measurements where there is some degree of estimation uncertainty). The scope should exclude auditing considerations relating to financial statement items measured at fair value where there is readily available and reliable information about the prices at which actual exchanges occur (e.g., active and open markets) and, consequently, do not involve estimation uncertainty.
3. The requirements of the Combined ISA should be applicable to both accounting estimates and accounting estimates involving measurement at fair value. Application material relating to fair value should be integrated fully with the material of ISA 540 (Revised), while retaining an appropriate focus on the inherent differences relating to accounting estimates that involve fair value measurement.
4. The Combined ISA should address relevant contemporary fair value auditing issues.
5. IAPS 1012, "Auditing Derivative Financial Instruments," should not be incorporated in the Combined ISA.

The basis of these proposals is explained in the Issues Paper in Agenda Item D.2. **Refer to paragraphs 8-25 of Agenda Item D.2.**

The Task Force's proposed Combined ISA 540-545 is presented in Agenda Item D.3, which is to be considered by the IAASB as a first read at its September 2006 meeting. **Refer to Agenda Item D.3.**

Matters for Consideration by the IAASB CAG:
<p>The Representatives are asked to review paragraphs 8-25 of Agenda Item D.2 and the proposed Combined ISA in Agenda Item D.3, and for their views on whether the combination works, and if not, why. In particular, Representatives are asked whether they:</p> <ul style="list-style-type: none">• Support the basis on which the combination is proposed, and whether they agree with the proposed scope of the Combined ISA?• Agree with the proposed structure, and view the requirements as being applicable to both estimates and estimates measured at fair value?• Believe that relevant material from ISA 545 has been incorporated appropriately, and that

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relevant contemporary fair value auditing issues have been adequately addressed? If not, what further considerations are needed?

- Agree that it is neither practical nor appropriate to attempt to subsume IAPS 1012 in the proposed Combined ISA?

Discussion by, and input from, Representative as to whether the proposed combination makes sense in light of current financial reporting standards and the direction the future direction that they might take will be of particular relevance to the work of the Task Force and IAASB.

Representatives are asked to note that changes in Agenda Item D.3 that relate to the incorporation of relevant material from ISA 545 are shown in mark-up and highlight. The other mark-ups relate to redrafting of ISA 540.

Material Presented – IAASB CAG REFERENCE PAPERS ONLY

Agenda Item D.1	Proposed ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other Than Those Involving Fair Value Measurements and Disclosures)” (September 2006 IAASB Agenda Item 3-A)
Agenda Item D.2	Issues Paper – Redrafting of ISA 540, and Combination of ISAs 540 and 545 (September 2006 IAASB Agenda Item 3-B)
Agenda Item D.3	Proposed Combined ISA 540-545, “Auditing Accounting Estimates, Including Those Measured at Fair Value, and Related Disclosures” (September 2006 IAASB Agenda Item 3-C)

The remainder of the September 2006 IAASB meeting material is available from <http://www.ifac.org/IAASB/Meeting-BGPapers.php?MID=0076>.