

IAASB CAG REFERENCE PAPER

IAASB CAG Agenda (September 2006)

Agenda Item D.2

Accounting Estimates—Issues Paper – September 2006 IAASB Agenda Item 3-B

Issues Paper – Redrafting of ISA 540, and Combination of ISAs 540 & 545

Introduction

1. This Paper is structured in the following sections:

Section I: Redrafting of ISA 540 (Revised)

Section II: Combination of ISA 540 (Revised) and ISA 545

Section III: Way Forward

Section I: Redrafting of ISA 540 (Revised)

DISPOSITION OF THE PRESENT TENSE IN ISA 540 (REVISED)

2. Agenda Item 3-E summarizes the proposed disposition of the present tense and other statements in ‘close-off’ ISA 540 (Revised). The Task Force found relatively few sentences that, in its view, warrant elevation as requirements. The majority of those not elevated describe either some of the procedures that the auditor might undertake to fulfill a requirement – none of which the Task Force view as necessarily the most effective approach in all circumstances; or matters that the auditor may consider – all of which appear to help guide the work of the auditor but not necessarily significantly influence a decision to be made in judging how to apply a requirement.
3. The Task Force, however, considers the elevation of the thrust of the material relating to ‘narrowing the range’ (where the auditor chooses to develop a range to evaluate management’s point estimate) as essential to the aim of the ISA. It has not elevated the guidance that describes how the auditor is expected to narrow the range, but rather the end-point where the auditor is reasonably considered to have a range that is sufficiently narrow for audit purposes. This emphasizes appropriately the end and not the means. Proposed redrafting is shown in paragraphs 10(d) and A86 in Agenda Item 3-C.

NATURE OF THE ISA, AND AUDITOR’S OBJECTIVE

4. As a topic-specific standard, ISA 540 is based on, and amplifies, the requirements and guidance in the IAASB’s audit risk standards and other ‘umbrella’ ISAs. The Task Force is of the view that, as such, some reference should be made to this fact particularly in light of the introduction of an objective for which some form of obligation may attach (subject to debate by the IAASB in September in connection with the Clarity project). Accordingly, it is proposed that a clarification of the scope of the ISA be made. The wording suggested by the Task Force in paragraph 1 in Agenda Item 3-C draws on the wording used in ISA 240 to describe its relationship to other ISAs.
5. With regard to the objective of the auditor, the Task Force understands that the Clarity Task Force is proposing to clarify the relationship between the concepts of reasonable assurance, sufficient appropriate audit evidence, and the reduction of audit risk to an acceptably low level. On that basis, the Task Force believes that the objective proposed is appropriate. It also

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believes that reference in the objective to the applicable financial reporting framework is unnecessary and, accordingly, should be removed.

APPLICATION AND OTHER EXPLANATORY MATERIAL

6. The Task Force is satisfied that the application and other explanatory material contains sufficient guidance relevant to a proper understanding of how the requirements may be applied in the audit of an SME, and that it has been streamlined (e.g., bullet points) where appropriate to improve readability.

Action Requested

The IAASB is asked to:

- Consider Agenda Item 3-E and to advise whether it agrees with the proposed disposition of the present tense and other statements in ISA 540 (Revised).
- Review the changes shown in mark-up in Agenda Item 3-C, and to advise whether it agrees with the proposed redrafting.

Note: Changes shown in mark-up relate to the redrafting of ISA 540; changes shown in mark-up and highlight relate to the revision of ISA 540 to deal with the issue of fair values, as discussed below.

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Section II: Combination of ISA 540 (Revised) and ISA 545

A. Recommendations

7. The following summarizes the main recommendations of the Task Force:
- ISAs 540 (Revised) and 545 should be combined in one ISA (Combined ISA).
 - 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.
 - 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.
 - The Combined ISA should address relevant contemporary fair value auditing issues.
 - IAPS 1012, “Auditing Derivative Financial Instruments” should not be incorporated in the Combined ISA.

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COMBINATION

8. Several factors have persuaded the Task Force to conclude that ISAs 540 (Revised) and 545 should be combined. First, as financial reporting standards move further towards fair value measurement in general, the distinction between estimates and fair values is becoming more difficult to draw. The Task Force is of the opinion that unless a clear distinction between the two can be made, the auditor will be faced with the difficulty of establishing “which ISA the auditor should be in.” This view was supported by one CAG member who advised in 2005 to deal with the conceptual distinction between estimates and fair values in auditing standards as a secondary concern.
9. Second, maintaining a separate ISA on fair values appears to have little foundation from an auditing point of view, as similar approaches are often taken to the audit of either estimates or fair values (even though the nature of, and sources of evidence for, assumptions may differ – see discussion below).
10. Third, references to fair value measurement in financial reporting frameworks are increasing predominantly in connection with the measurement of fair value for items where there is a need to derive fair value through a process of estimation. Recent academic literature¹ broadly considers fair values a specific class of estimates, and some frameworks take up the notion of greater uncertainty associated with certain fair value measurements. Accordingly, the Task Force believes that the incorporation of ISA 545 in ISA 540, and thereby a change in the focus of ISA 545 to areas of estimation uncertainty and risk, is appropriate in the circumstances. Further, it believes that the combination enhances, rather than diminishes, the distinction between estimates and estimates involving fair value measurement specifically because it draws upon the similarities between the two and contrasts their subtle differences.
11. Fourth, combining ISAs 540 (Revised) and 545 effectively revises ISA 545 in an efficient and effective manner, aligning it with the audit risk model and improving it for matters covered as part of the revision of ISA 540 (e.g., use of ranges, indicators of bias, etc.). Having the opportunity to reconsider ISA 545, the Task Force does not believe that a separate revision of ISA 545 on a stand alone basis would be fundamentally different to the approach taken to revising ISA 540.
12. Finally, in light of the principles of the Clarity project and as indicated by a number of respondents to the exposure of ISA 540 (Revised), it minimizes the extent of unnecessary duplication. The Task Force is of the view that it is both practical and appropriate to combine the two ISA, and is satisfied that the Combined ISA is understandable, readable and effective.

SCOPE

13. ISA 545 was developed before the audit risk standards were finalized and therefore does not adopt fully a risk based approach. Further, it deals with all fair value measurements, from

¹ Auditing Fair Value Measurements: A Synthesis of Relevant Research: Martin, Rich, Wilks, May 2006

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simple to complex. The Task Force believes that the appropriate scope of any standard dealing with fair values should focus on areas of risk. This implies the need to consider auditing issues for fair value measurements that involve some degree of estimation uncertainty (and hence, estimation), rather than on those that do not; the latter typically being the fair value of items where there is an open and active market. The Task Force doubts there is a need for the IAASB to issue guidance on fair value measurements that are directly verifiable. This is a critical presumption underlying the basis for the proposed combination.

STRUCTURE

14. In considering the combination, the Task Force is of the view that it can work only if the Combined ISA presents in an integrated and coherent manner audit considerations relating to accounting estimates irrespective of the basis of measurement. Further, requirements and guidance pertaining to issues arising when fair value measurement is involved cannot be presented as a ‘tack-on’ suggesting more work, but rather need to be integrated so that any necessary change in focus of the auditor’s work can be understood in context.
15. ISA 540 (Revised), however, was not drafted with the consideration of auditing fair values specifically in mind. There is an argument that the focus and orientation of ISA 540 (Revised) may not be wholly suitable to the audit of fair value measurements. Specifically, the measurement of fair values is premised on basis of exchange at a point in time and a focus on market-participant assumptions, whereas estimates deal with the outcome of future events and entity-specific / management-generated assumptions. This leads to a focus on different types of audit evidence when auditing assumptions relating to fair value.
16. The Task Force accepts this as a general² point. Accordingly, in considering the combination of the ISAs, the Task Force evaluated whether the requirements and application material of ISA 540 (Revised) are fully applicable to the audit of fair values. The Task Force is of the view that the ‘principle-based’ requirements of ISA 540 (Revised) require some, but not substantive, change in order to be applicable to both.
17. The application material of ISA 540 (Revised) and the explanatory material of ISA 545 required more extensive redrafting in order to highlight the inherent differences between estimates and fair value estimates and the consequential impact on the auditor’s consideration of assumptions and the methods used by management in making the required estimates. Further redrafting was also required to the guidance in both ISAs 540 (Revised) and 545 to achieve an appropriate balance in terms of the nature and extent (i.e., specificity) of the combined application material.

² Arguably, however, there is a dichotomy in the accounting literature relating to fair values. The application of the ‘entity-independent’ definition of fair value requires consideration of the underlying valuation premise, being either value-in-use or value-in-exchange; the former subsumes entity-specific considerations.

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CONTEMPORARY FAIR VALUE AUDITING ISSUES

18. Because the combination revises, rather than redrafts, ISA 545, the Task Force considered the issue of whether the requirements and application material pertaining to fair values are complete. This involved consideration of whether all material from ISA 545 of continuing relevance has been brought forward (see section B: Disposition of Material in Extant ISA 545), and whether the Combined ISA is complete in terms of addressing contemporary fair value auditing issues.
19. The Task Force noted certain relevant fair value auditing considerations that are not addressed at present in extant ISA 545. These included:
 - The need for management to use assumptions that reflect, or are consistent with, those that market participants would use in determining fair value, recognizing that management may be faced with a number of different assumptions coming from different market participants.
 - The fact that more variation usually exists between fair value amounts recognized in the prior period financial statements and the actual outcome or re-estimation in the current period financial statements, because of on-going changes in the environment relevant to the measurement of fair value.
 - The reliability and relevance of sources of market-participant assumptions (e.g., in the case of vendor-supplied valuations).
 - The judgmental nature of decisions relating to whether the criteria of the applicable financial reporting framework requiring or permitting measurement at fair value have been met (e.g., is there in fact a potential for accounting mismatch?).
 - The complexity of valuation models used, including the accuracy and reliability of the variables that the models' incorporate.
20. These points have been incorporated into the guidance of the proposed Combined ISA 540-545.

Action Requested

The IAASB is asked to review the proposed Combined ISA in Agenda Item 3-C, and for its opinion on whether the combination works, and if not, why. In particular, does the IAASB:

- Support the basis on which the combination is proposed?
- Agree with the proposed scope, and how it is expressed?
- 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 relevant contemporary fair value auditing issues have been adequately addressed? If not, what further considerations are needed?

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In conducting its review, the IAASB is asked to note that changes in Agenda Item 3-C that relate to the combination are shown in **mark-up and highlight**. The other mark-ups relate to the redrafting of ISA 540.

B. Disposition of Material in Extant ISA 545

21. Agenda Item 3-F identifies the disposition of extant ISA 545. This is provided for reference purposes of the Board. There are three main areas where some material in extant ISA 545 (that is not already covered by ISA 540) has not been brought forward:
 - The requirement to determine the need to use an expert, on the basis that this matter is to feature in revised ISA 620, “Using the Work of an Expert.”
 - Requirements and material that are repetitive of, or otherwise covered by, material in other ISAs (e.g., ISAs 315, 500, 260, 402, 505, etc.).
 - Certain examples not considered necessary to further the point already made in the material in the Combined ISA.
22. The Task Force is satisfied that all material within ISA 545 of continuing relevance (in the context of the proposed scope of the Combined ISA) has been appropriately considered, and that the combination does not result in a significant weakening of the extant fair value standard.

Action Requested

The IAASB is asked to advise whether there remains any material in ISA 545 that ought to be brought forward to the Combined ISA.

C. IAPS 1012 – Derivatives

23. Some respondents to the exposure of ISA 540 (Revised), and other stakeholders, have suggested that IAPS 1012 be subsumed in the process of updating and revising ISA 545.
24. The Task Force does not recommend that IAPS 1012 be incorporated in the Combined ISA. The IAPS deals with a broad range of considerations relating to requirements contained in many of other the ISAs, and in a level of detail that is unique to IAPSs and, in general, inconsistent with that of the ISAs. Attempting to incorporate the material in the Combined ISA would fundamentally change the focus and balance of the Combined ISA. The alternative of adopting only parts of IAPS 1012 into the Combined ISA would leave the IAPS only partially complete.
25. Accordingly, the Task Force recommends that IAPS 1012 be retained as is until the issue of the treatment of IAPSs that are of continuing relevance is resolved.

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Section III: Way Forward

26. Subject to IAASB agreement on the proposed combination of ISAs 540 and 545 as the appropriate way forward, the Task Force intends to present a revised Combined ISA for approval by the IAASB as an exposure draft at its December 2006 meeting.