



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

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Committee: IAASB Consultative Advisory Group

Meeting Location: New York

Meeting Date: April 2-3, 2007

Report Back—Accounting Estimates

Objective of Agenda Item

To provide a brief report back on the September 11-12, 2006 proposals of Representatives on the proposed ISA 540 (Revised and Redrafted), “Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures.”

The IAASB approved the “close off”¹ version of proposed ISA 540 (Revised), “Auditing Accounting Estimates and Related Disclosures (Other than those Involving Fair Value Measurements and Disclosures) in September 2006. The IAASB concluded that re-exposure of the requirements and guidance was not necessary. Mr. Sylph confirmed that the IAASB had followed due process with regard to the project.

The IAASB approved the Exposure Draft (ED) of proposed ISA 540 (Revised and Redrafted) in December 2006. This ED combines ISAs 540 (Revised) and material of continuing relevance in extant ISA 545, “Auditing Fair Value Measurements and Disclosures” in one ISA, such that the proposed requirements and guidance are applicable to the audit of accounting estimates, including fair value accounting estimates, and related disclosures. The comment period on the ED ends April 30, 2007. IAASB review of comments received is scheduled for September 2007.

September 11-12, 2006 CAG Proposals

At the September 11-12, 2006 CAG meeting, Representatives discussed both the proposed “close off” version of ISA 540 (Revised) and the draft proposed ISA 540 (Revised and Redrafted). The approved versions of these documents took into account the Representative’s comments, as explained below, and other improvements as agreed by the IAASB. The approved documents were however not substantively different from those discussed by the CAG.

Below are extracts from the minutes of the September 11-12, 2006 CAG meeting² and an indication of how the IAASB Task Force or the IAASB responded to the Representatives’ comments.

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.

² The minutes will be approved at the April 2007 IAASB CAG meeting.

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Representatives' comments	IAASB task force/IAASB response
Scope	
<p>Ms. Sucher and Mr. Gutterman noted that the scope of the combined ISA should not exclude audit considerations relating to 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). Even in such cases there will be some form of estimation uncertainty, and even if an item does not involve estimation uncertainty, it may still require the auditor to consider, for example, whether the right market was chosen. Ms. Todd McEnally supported these views.</p>	<p>The Task Force and IAASB agreed with these observations. Accordingly, ED ISA 540 (Revised and Redrafted) was set to apply to all accounting estimates, including fair value accounting estimates, and disclosures of amounts that involve estimation uncertainty. Further, the ED explains that even in the case for some financial statement items where there is an active and open market that provides readily available and reliable information on the prices at which actual exchanges occur, estimation uncertainty may exist, for example where valuation of quoted securities held for investment purposes at the listed market price requires adjustment under the entity's applicable financial reporting framework if the holding is significantly large in size or is subject to restrictions in marketability, where only bid and asked prices are available, or where there are multiple sources of quoted market prices. See paragraphs 2 & A6 of ED ISA 540 (Revised and Redrafted).</p>
Measurement Objectives	
<p>Ms. O'Malley was of the view that combining ISAs 540 and 545 is an imperative. The combination emphasizes the fact that fair values are just one kind of estimate on a spectrum. At one end of the spectrum, an estimate is a forecast of an actual outcome that will be observable. At the other end, an estimate of fair value is an estimate of the position today. It is not attempting to predict the future outcome, and any observed outcome will almost invariably have been affected by events subsequent to the measurement date. Accordingly, it is important of to emphasize the need to understand the measurement objective of the financial reporting framework and to confirm that the entity's models are consistent with that measurement objective. Mr. Roussey supported this view, but cautioned against the potential</p>	<p>The Task Force and IAASB agreed with these observations. Accordingly, ED ISA 540 (Revised and Redrafted) sets out in its introduction the fact that how management makes an accounting estimate, and the auditor's consideration thereof, depends on the measurement objective of the accounting estimate. That measurement objective will vary depending on the nature of the accounting estimate: from a forecast of the future outcome of a transaction, event or condition giving rise to the need for the accounting estimate (the more familiar 'accounting estimates') to the estimation of the current price at which a hypothetical current transaction would have occurred ('fair value accounting estimates'). The Task Force and IAASB believe that this provides essential context for the proper application of the requirements</p>

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complexity and length of a combined ISA.	<p>of the proposed ISA. Further, ED ISA 540 (Revised and Redrafted) makes reference, where appropriate, to the auditor's understanding of those measurement objectives in applying the relevant requirements. See paragraphs 3, A28, A34-A35, A56 and A65 of ED ISA 540 (Revised and Redrafted).</p> <p>The Task Force and IAASB believe that the combination of ISAs 540 and 545 is appropriate, and that the result is a document that is comprehensive, understandable and readable.</p>
Maintenance of Requirements	
Mr. Damant asked the Task Force to ensure that, in combining ISAs 540 and 545, the requirements remain requirements – that is, requirements should not become guidance.	<p>All requirements of the approved “close off” version of ISA 540 (Revised) have been retained as such in ED ISA 540 (Revised and Redrafted).</p> <p>The Task Force and IAASB also carefully consider the material of extant ISA 545. In December, the IAASB agreed that the extant requirement in ISA 545 dealing with the auditor's determination of the need to use an expert's should be retained pending finalization of the work to revise ISA 620, “Using the Work of an Expert.” In addition, it agreed that the extant requirement for the auditor to evaluate whether the method of measurement used is appropriate in the circumstances should be retained. See paragraphs 12 and 13(b)(i), respectively, of ED ISA 540 (Revised and Redrafted).</p> <p>Taking the above into account, the Task Force and IAASB concluded that all remaining material within ISA 545 of continuing relevance has been appropriately considered.</p>
IAPS 1012	
Mr. Damant suggested that the Task Force consider whether, based on the importance of derivatives and their pervasive effect on future cash flows, the guidance in IAPS 1012 should be included in the combined ISA.	The Task Force and IAASB are of the view that the principles relating to the audit of derivatives and their disclosure in the financial statements are captured in ED ISA 540 (Revised and Redrafted). IAPS 1012 provides additional implementation guidance.

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	<p>The Task Force and IAASB do not believe that it would be appropriate to incorporate IAPS 1012 in the proposed 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. Accordingly, incorporating the material would fundamentally change the focus and balance of the combined ISA. Further, it would create a very complex and long document, a matter about which one CAG Representative expressed caution. The alternative of adopting only parts of IAPS 1012 into the combined ISA would leave the IAPS only partially complete.</p> <p>Accordingly, the Task Force and IAASB agreed that IAPS 1012 be retained as is until the issue of the treatment of IAPSs that are of continuing relevance is resolved.</p>
Other Matters	
Mr. Damant encouraged the IAASB to comment on the issue of verifiability addressed in the IASB Discussion Paper "Preliminary Views on an improved Conceptual Framework for Financial Reporting: The Objective of Financial Reporting and Qualitative Characteristics of Decision-useful Financial Reporting Information."	IFAC and the IAASB have commented on the IASB Discussion Paper.

The close off version of ISA 540 (Revised) is available from
<http://www.ifac.org/IAASB/Meeting-FileDL.php?FID=2591>.

The ED, Proposed ISA 540 (Revised and Redrafted), is available from
<http://www.ifac.org/Guidance/EXD-Details.php?EDID=0069>.

IAPS 1012 is available from
http://www.ifac.org/Members/Source_Files/Auditing_Related_Services/2007_Handbook/2007_A245_IAPS_1012.pdf.

Note from IAASB CAG Chair

The proposed ISA on Accounting Estimates is especially important for what is in a sense an external reason. It comes into the centre of the picture as a result of the fact that there is a

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considerable move to fair values in many accounting jurisdictions, in particular those governed by IFRSs, and this trend may go further. Many preparers and other are highly concerned about this move. Hence the importance of the ISA on Accounting Estimates, which now includes a treatment of fair values. However, the discussion in the CAG should not reopen the question as to whether these two aspects of the matter should have been left in separate ISAs.

One point which is made is that it is not so much what is in the proposed ISA which raises questions but rather what might be added. In particular, it is suggested that there could be added a more detailed treatment of disclosures, and in the case of financial instruments more detail on the auditing of models which are growing more complex and more generally used. However, some of these matters might be better dealt with in implementation guidance or in a practice statement. Note the discussion of IAPS 1012 in the above table.